

**STATEMENT OF DETERMINATION AND ORDER  
OF THE SECRETARY OF FOOD AND  
AGRICULTURE REGARDING PROPOSED  
AMENDMENTS TO THE STABILIZATION AND  
MARKETING PLANS FOR MARKET MILK FOR  
THE NORTHERN AND SOUTHERN CALIFORNIA  
MARKETING AREAS BASED UPON A PUBLIC  
HEARING HELD ON SEPTEMBER 21, 1999**

**Signed in the Office of the Secretary on  
Thursday, October 21, 1999**

## SUMMARY OF DETERMINATIONS

A duly noticed public hearing was held by the Department of Food and Agriculture (CDFA) on September 21, 1999, to consider adjustments to the pricing formula used to calculate minimum farm prices for Class 1 milk. At that hearing, which included a period for filing post-hearing briefs, testimony and evidence were introduced into the hearing record regarding proposals for adjustments to the formula and their effect on Class 1 prices.

In weighing the testimony and evidence on the hearing record, CDFA has made the following determinations:

- That the base price in the Class 1 pricing formula will be lowered by five cents per gallon (57 cents per hundredweight of whole milk).
- That adjustments will be made to cause California's Class 1 farm prices to better track with similar prices in neighboring states. These adjustments include calculating and announcing minimum Class 1 prices on a monthly basis rather than a bimonthly basis. They also include adjusting the procedure for placing values on the components of milk. These adjustments will result in virtually no effect on the Class 1 price.

The effect of these determinations will be that each month the announced Class 1 minimum farm price for whole milk will be five cents per gallon less than if no changes had been made. Also, for the month of November 1999, the minimum Class 1 farm price will be an additional 15 cents lower per gallon for a total reduction of 20 cents. This one time 15-cent reduction is the result of the decreased market value of the commodity prices referenced in the Class 1 pricing formula. Under the previous method for calculating the Class 1 price, the decrease in commodity prices would not have been reflected in the farm price until December.

These determinations will lower the minimum farm price dairy processors must pay for milk received from dairy farmers (producers) and therefore, their raw product cost. The effect of these changes may, or may not, affect the wholesale and retail prices of milk. These prices are not regulated by the State and are determined by individual firm's pricing policies.

**SUMMARY:** The determination to make amendments to the current Stabilization and Marketing Plans for Northern and Southern California (Plans) is based on testimony and evidence received at a public hearing held on September 21, 1999 in Sacramento, California. These determinations are further based on written comments submitted prior to the close of the hearing record and on written briefs filed within the allowed filing period. The statement of determination will be discussed in the following Sections:

- I. Introduction:** a broad outline of statutes and facts giving rise to the hearing. Page 4.
- II. Background:** an overview of regulation of the dairy industry. Page 6.
- III. Statutory Criteria for Establishing and Amending the Stabilization and Marketing Plans and the Pooling Plan:** an analysis of the criteria set forth in the Food and Agricultural Code for establishing or amending the Stabilization and Pooling Plans. Page 8.
- IV. Current Industry Conditions Relative to the Statutory Criteria:** current information concerning the condition of the dairy industry in California. Page 12.
- V. Proposals and Testimony:** a review of the hearing record. Page 22.
- VI. Review of Previous Hearings:** a review of the last hearings held on this topic and the determinations made as a result of those hearings. Page 34.
- VII. Analysis of the Hearing Record:** a discussion of the changes to the Plans as proposed in the hearing record. Page 36.
- VIII. Findings of the Department of Food and Agriculture.** Page 51.
- IX. Order of the Secretary of Food and Agriculture.** Page 52.

## SECTION I INTRODUCTION

California Food and Agricultural Code Section 61801, *et seq.*, provides the authority, procedures and standards for establishing minimum farm prices by the California Department of Food and Agriculture (Department) for the various classes of milk that processors (handlers) must pay for milk purchased from dairy farmers (producers). These statutes provide for the formulation and adoption of Milk Stabilization and Marketing Plans for Market Milk (Plans).

The statutes identify legal requirements and public policies that the Department is charged with implementing and enforcing. The determinations set forth in this decision are made pursuant to the authority vested in the Department by statute and in furtherance of the important State purposes embodied in the governing statutes.

On its own motion, the Department held a public hearing on Tuesday, September 21, 1999 in Sacramento, to consider possible amendments to the Stabilization and Marketing Plans for Market Milk. The purpose for the hearing was to review the Class 1 pricing formula, including but not limited to, price alignment with adjacent states and federal milk marketing order reform.

A total of nine witnesses testified including the Department's witness. Of those testifying:

- one represented a processor trade association (Dairy Institute of California),
- two represented producer trade associations (Western United Dairymen, and Milk Producers Council)
- one represented a trade association of cooperatives (Alliance of Western Milk Producers)
- two represented cooperatives (Land O' Lakes, and Humboldt Creamery Association)
- two represented proprietary processors (Crystal Cream and Butter Company, and Stremics Heritage Foods)

The only alternative proposal received by the September 7, 1999, deadline was from the Dairy Institute of California. A second proposal was submitted by Western United Dairymen at the public workshop on September 14. A revised proposal was submitted by Western United Dairymen the day before the hearing, September 20. A third proposal was submitted by Dairy Farmers of America, also on September 20. At the hearing, the Alliance of Western Milk Producers, Crystal Cream & Butter Company, and Land O' Lakes each presented proposals.

In addition to the nine witnesses and six proposals, eight additional interested parties submitted written comments prior to the close of the hearing on September 21. Six interested parties submitted post-hearing briefs by the October 1 deadline. Attachment A-1 summarizes the positions of all interested parties.

## **References to Hearing Testimony and Evidence**

This Statement of Determination applies only to the Class 1 hearing held September 21, 1999. However, the hearing record referenced four prior hearings. In turn, each of these four hearings referenced additional previous hearings. Therefore, care must be taken that any testimony or evidence cited is attributed to the correct hearing. This can be accomplished by citing the date for any piece of testimony from a prior hearing. For any evidence from the current hearing, no date is included. Thus, the twelfth exhibit entered into the current hearing record, the “*California Dairy Industry Statistics, 1998*,” can be referred to as HE#12. While, HE#4a/7-II-97 refers to part “a” of the fourth exhibit entered into the hearing record held on February 7, 1997, the “*Alternative Proposal received from Advanced Milk Commodities . . .*”

## **SECTION II BACKGROUND**

Over 95 percent of the market grade (Grade A) milk produced in the United States is subject to regulation under federal and/or state marketing programs. All grades of milk are affected by the federal support price system.

In 1998, California was the largest milk producing state in the United States. California dairy farmers marketed 27.6 billion pounds of milk, which represented 17.5 percent of the nation's marketings. California's share of national production is up from 12.8 percent in 1988 and 9.8 percent in 1978.

California has also seen increases in cow numbers. In 1998, California had more cows than any other state in the United States: 1.4 million adult milk cows representing 15.3 percent of the nation's total herd. California's share of US cow numbers is up from 10.6 percent in 1988 and 7.8 percent in 1978.

Milk has three basic components: butterfat (fat), solids-not-fat SNF (containing protein, other solids) and water. In both California and federal milk marketing orders, milk is priced on at least some of these three components. In California, Class 1 milk, which is milk used for fluid purposes, is priced on fat, SNF and water. In all federal orders Class I milk is priced on fat and skim.

In California, Class 1 farm prices adjust every two months and reflect changes in dairy commodity prices. Federal order Class I prices are changed on a monthly basis.

### **Pricing Formulas**

Across the whole country, federal Class I prices are established as differentials above the basic formula price (BFP). The Class I differentials range in value from \$1.20 to \$4.18 depending upon the milk marketing order. California's pricing system does not use differentials to establish a Class 1 price. Instead, a commodity reference price (CRP) is used to establish a base price. The CRP changes with changes in the value of Cheddar cheese and whey butter. The difference between the CRP and a historic price is allocated to fat, SNF and the fluid carrier on a 40% — 40% — 20% basis, respectively.

To assist in establishing farm prices, the Department conducts milk production cost surveys of 290 of California's 2,100 Grade A dairies. The Department also conducts manufacturing cost studies of all major California plants manufacturing butter, NFDM and Cheddar cheese. The Department compiles and publishes monthly and annual dairy statistics including production, usage, sales, and trends. Confidential information collected from California dairy farmers and handlers is available

to Department staff. The Department monitors and maintains information on milk trends, programs and policies used in other parts of the nation.

### **Marketing Areas**

To achieve their objectives, both the Department and USDA establish, modify and consolidate marketing areas. Marketing areas are established on a regional basis where milk production and marketing conditions are similar. When marketing areas were first established in the 1930's, the ability to ship milk was limited due to its perishability. Therefore, milk production and processing tended to be local in nature. Milk supply areas (milksheds) were small, as were the marketing areas.

In the mid 1950's, there were 37 marketing areas in California, each typically composed of one to three counties or sections of counties. Also several isolated areas of the state were unregulated. Marketing areas were consolidated and unregulated areas were brought into existing marketing areas as technology improved the ability to ship bulk and packaged milk greater distances. Currently, there are two marketing areas and one unregulated area in California.

This same pattern of consolidation has also occurred in federal milk marketing orders (federal orders). In 1960, there were 80 federal orders. Currently there are only 31 federal orders, but USDA is working toward implementing a reform package that will reduce the number of federal milk marketing orders to 11.

### **Federal Milk Support Program**

In addition to federal and state marketing order programs, the federal government also has a dairy support price program. The federal government establishes a minimum target support price as a floor for the milk dairy farmers sell to processors. This price is currently \$10.10 per hundredweight for milk testing 3.5 percent fat (88 cents per gallon of whole milk). The federal government does not buy milk from dairy farmers at the target price. Instead, it stands ready, through the Commodity Credit Corporation (CCC), to buy unlimited quantities of butter, nonfat dry milk (NFDM), and Cheddar cheese from processors. It purchases these products at prices that will, on average, enable the processors to pay dairy farmers the target price. These per-pound, support purchase prices are currently \$0.65, \$1.05 and \$1.13 respectively, for bulk butter, non-fortified NFDM, and block Cheddar cheese.

**SECTION III**  
**STATUTORY CRITERIA FOR ESTABLISHING AND AMENDING**  
**THE STABILIZATION AND MARKETING PLANS AND THE POOLING PLAN**

In evaluating the operation of the Plans, and in considering proposed modifications to those Plans, the Department seeks to further the legal requirements and important public policies set forth in the Food and Agricultural Code. Below are the statutes that direct the Department's actions that are applicable to the September 21, 1999 hearing.

61801. The production of market milk is hereby declared to be a business affected with a public interest. The provisions of this chapter are enacted in the exercise of the police powers of this state for the purpose of protecting the health and welfare of the people of this state.  
**[Public Interest]**

61802. The Legislature hereby declares all of the following:

(a) Market milk is a necessary article of food for human consumption.

(b) The production and maintenance of an adequate supply of healthful market milk of proper chemical and physical content, free from contamination, is vital to the public health and welfare, and the production, transportation, processing, and storage of market milk in this state is an industry affecting the public health. **[Public Interest]**

(c) Because of the perishable quality of milk, the nature of milk production, the varying seasonal production and demand factors, and other economic factors affecting the milk industry, the potential exists for economic disruption, in the absence of regulation, in the production, marketing, and sale of market milk which may constitute a menace to the health and welfare of the inhabitants of this state and may tend to undermine sanitary regulations and standards of content and purity, however effectually the sanitary regulations may be enforced. **[Public Interest]**

(d) Health regulations alone are insufficient to prevent economic disturbances in the production of milk which may disrupt the future supply of market milk and to safeguard the consuming public from future inadequacy of a supply of this necessary commodity.  
**[Public Interest]**

(e) It is the policy of this state to promote, foster, and encourage the intelligent production and orderly marketing of commodities necessary to its citizens, including market milk, and to eliminate economic waste, destructive trade practices, and improper accounting for market milk purchased from producers. **[Public interest]**

(f) It is recognized by the Legislature that the economic factors concerning the production, marketing, and sale of market milk in California may be affected by the national market for milk for manufacturing purposes. **[Farm and Commodity Price Relationships]**



(g) It is recognized by the Legislature that in recent years the supply of manufacturing milk in California, as defined in Section 32509, has consistently declined and continues to decline, and that market milk has virtually supplanted manufacturing milk for manufacturing purposes in this state, and that it is therefore necessary to conform the pricing standards governing minimum producer prices for market milk established under this chapter to current economic conditions.

(h) It is recognized by the Legislature that the levels of retail prices of milk and milk products paid by consumers are affected by a large number of economic and other factors apart from minimum producer prices for market milk established under this chapter, many of which factors are not within the power of the director to regulate or control, particularly since the Legislature repealed provisions concerning establishment of minimum wholesale and retail prices. It is further recognized by the Legislature that, in order to accomplish the purpose of this chapter and to promote the public health and welfare, it is essential to establish minimum producer prices at fair and reasonable levels so as to generate reasonable producer incomes that will promote the intelligent and orderly marketing of market milk in the various classes, and that minimum producer prices established under this chapter should not be unreasonably depressed because other factors have affected the levels of retail prices paid by consumers. [***Public Interest; Other Factors***]

61805. The purposes of this chapter are to do all of the following:

(a) Provide funds for administration and enforcement of this chapter, by assessment to be paid by producers and handlers of market milk in the manner prescribed in this chapter.

(b) Authorize and enable the director to prescribe marketing areas and to determine minimum prices to be paid to producers by handlers for market milk which are necessary due to varying factors of costs of production, health regulations, transportation, and other factors in the marketing areas of this state. In determining minimum prices to be paid producers by handlers, the director shall endeavor under like conditions to achieve uniformity of costs to handlers for market milk within any marketing area. However, no minimum prices established or determined under this chapter shall be invalid because uniformity of cost to handlers for market milk in any marketing area is not achieved as a result of the minimum producer prices established determined. [***Equity; Other Factors***]

(c) Authorize and enable the director to formulate stabilization and marketing plans, subject to the limitations prescribed in this chapter with respect to the contents of the stabilization and marketing plans, and to declare the plans in effect for any marketing area.

(d) Enable the dairy industry, with the aid of the state, to develop and maintain satisfactory marketing conditions, bring about and maintain a reasonable amount of stability and prosperity in the production of market milk, and provide means for carrying on essential educational activities. [***Public interest***]

61806. It is the intent of the Legislature that the powers conferred in this chapter shall be liberally construed.

62062. Each stabilization and marketing plan shall contain provisions whereby the director establishes minimum prices to be paid by handlers to producers for market milk in the various classes. The director shall establish the prices by designating them in the plan, or by adopting methods or formulas in the plan whereby the prices can be determined, or any combination of the foregoing. If the director directly designates prices in the plan, the prices shall be in reasonable and sound economic relationship with the national value of manufactured milk products. If the director adopts methods or formulas in the plan for designation of prices, the methods or formulas shall be reasonably calculated to result in prices that are in a reasonable and sound economic relationship with the national value of manufactured milk products. [***Farm and Commodity Price Relationships***]

In establishing the prices, the director shall take into consideration any relevant economic factors [***Other Factors***], including, but not limited to, the following:

(a) The reasonableness and economic soundness of market milk prices for all classes, giving consideration to the combined income from those class prices, in relation to the cost of producing and marketing market milk for all purposes, including manufacturing purposes. In determining the costs, the director shall consider the cost of management and a reasonable return on necessary capital investment. [***Production Costs***]

(b) That prices established pursuant to this section shall insure an adequate and continuous supply, in relation to demand, of pure, fresh, wholesome market milk for all purposes, including manufacturing purposes, at prices to consumers which when considered with relevant economic criteria, are fair and reasonable. [***Supply, Demand, and Prices to Consumers***]

(c) That prices, including the prices of components of milk, established by the director for the various classes of market milk bear a reasonable and sound economic relationship to each other. [***Farm and Commodity Price Relationships***]

62062.1. Any designation of a Class 1 price by any method or formula that is used to develop Class 1 prices paid to producers in the various marketing areas, shall provide, on a calendar year basis, a statewide weighted average minimum price level for a hundred weight of milk testing 3.5 fat and 8.7 solids-not-fat (SNF) that is in reasonable relationship with minimum Class 1 milk prices paid to producers in contiguous states. If the statewide weighted average Class 1 prices paid to producers are not in a reasonable relationship with the Class 1 prices paid to producers in contiguous states, the Department shall immediately hold a hearing to consider adjustments to the Class 1 prices. [***Farm and Commodity Price Relationships***]

62700. The production and distribution of fluid milk and fluid cream is hereby declared to be a business affected with a public interest. The provisions of this chapter are enacted in the exercise

of the police powers of this state for the purpose of protecting the health and welfare of the people of this state. [***Public Interest***]

62701. It is hereby declared that fluid milk and fluid cream are necessary articles of food for human consumption; that the production and maintenance of an adequate supply of healthful milk of proper chemical and physical content, free from contamination, is vital to public health and welfare, and that the production, transportation, processing, storage, distribution and sale of fluid milk and fluid cream in the State of California is an industry, in whole and in part, affecting public health and welfare; that unfair, unjust, destructive and demoralizing trade practices have appeared within this industry and these practices constitute a menace to the health and welfare of the inhabitants of this state by threatening the stability of this industry and by thereby endangering the assurance to the people of the State of California of the maintenance of an adequate supply of this necessary commodity; that it is a policy of this state to promote, foster and encourage the intelligent production and orderly marketing of commodities necessary to its citizens, including fluid milk and fluid cream, and to eliminate speculation, waste, improper marketing, unfair and destructive trade practices, and improper accounting for milk purchased from producers [***Public Interest***].

**SECTION IV**  
**CURRENT INDUSTRY CONDITIONS**  
**RELATIVE TO THE STATUTORY CRITERIA**

**Public Interest**

**Legislative Declarations** — Below are declarations made by the statutes under which the Pooling Plan and the Stabilization Plans are promulgated regarding the dairy industry effects on the public's health and welfare. The pertinent Food and Agricultural Code sections follow each declaration.

1. The production and distribution of milk is a business affected with a public interest. Thus, the police powers of this state may be used for the purpose of protecting the public health and welfare (§61801 and §62700).
2. The production and maintenance of an adequate supply of milk is vital to the public health and welfare (§61802(b) and §62701).
3. Health regulations alone are insufficient to prevent economic disturbances in the production of milk. Thus in the absence of economic regulation, the potential exists for economic disruption which may constitute a menace to the public health and welfare (§61802(c) and §61802(d)).
4. By threatening industry stability, unfair, unjust, destructive and demoralizing trade practices constitute a menace to the public health and welfare. Thus, the regulatory provisions should promote intelligent production and orderly marketing, and should eliminate economic waste, destructive trade practices, and improper accounting (§61802(e) and §61701).
5. To promote the public health and welfare, it is essential to establish minimum producer prices at fair and reasonable levels (§61802(h)).
6. The regulatory provisions should result in uniformity of cost to handlers and should not restrict the free movement of fluid milk (§61805(b) and §62720).
7. The regulatory provisions should help develop and maintain satisfactory marketing conditions, and bring about and maintain a reasonable amount of stability and prosperity (§61805(d)).

**Dynamic Industry Conditions** – The relevant statutes recognize that conditions affecting the California dairy industry are subject to change over time. As such, the Department's regulation of the California dairy industry in accordance with the governing statutes and the public interest must

be modified when necessary to address issues created by changing conditions. Since the beginning of economic regulation in 1936, much has changed:

- Dramatic increases in total milk production have been matched by equally dramatic decreases in numbers of dairy farms and dairy processing plants. From 1936 to 1998, there has been a seven-fold increase in milk production from 4.2 billion pounds to 27.6 billion pounds. Data on numbers of producers and processors is not as extensive. However, from 1940 to 1998 there was an 88 percent decline in number of dairy farmers from 19,428 to 2,246. From 1960 to 1998 the number of dairy processors declined about 83 percent from about 600 to about 100. In addition to the decline in numbers, dairy processors have become more specialized. In 1960, many of the 600 processors made multiple class products. In 1998, most of the 100 processors specialize in only one or two classes. (See HE#8, HE#11 and HE#12.)
- Fluid milk products as a percent of total milk fat production declined from 65 percent in 1952 to 14 percent in 1998.
- The declining importance of milk fat has resulted in changes in producer pricing: fat basis until 1955; fat/skim basis from 1955 to 1962; mixed fat/skim and fat/solids-not-fat basis from 1962 to 1969; and fat/solids-not-fat basis since 1969.

## **Supply, Demand, and Prices to Consumers**

### **Supply**

**Milk Production and Supply.** The table below shows that California production compared to historic trends has increased faster than production nationally. From 1990 to 1998, California's production has increased by 32 percent while production nationwide only increased by 6 percent. During this same period, California's share of U.S. total production increased from 14.1 percent to 17.5 percent.

As evidenced by the Departmental exhibits, total California milk production continues to be enough to “. . . insure an adequate and continuous supply, in relation to demand, of pure, fresh, wholesome market milk for all purposes, including manufacturing purposes . . .” (§62062(b))

### **TOTAL ANNUAL MILK PRODUCTION**

**1990 – 1998**

(Million Pounds)

<b>Year</b>	<b>U.S Production</b>	<b>California Production</b>	<b>CA Share of U.S. (%)</b>
1990	148,313	20,947	14.1
1991	148,477	21,407	14.4
1992	151,647	22,095	14.5
1993	150,582	22,927	15.2
1994	153,664	25,242	16.4
1995	155,425	25,344	16.3
1996	154,259	25,861	16.8
1997	156,091	27,582	17.7
1998	157,441	27,607	17.5

Perhaps equally important with the actual production is the growing capability to produce more milk. As evidenced by the following chart, California's milk production capability has increased over time. While the total number of milk cows in the U.S. has decreased by about one million (or - 9.6%) from 1990 to 1998, the number of milk cows in California increased by over one quarter of a million (or +23%) from 1990 to 1998. During 1997 and 1998, the cow population increased at a rate of one thousand per month. In 1996, the cow population in California was growing at a rate of 10,000 cows per month.

### **TOTAL NUMBER OF MILK COWS**

**1990 – 1998**

(1000s)

<b>Year</b>	<b>U.S Milk Cows</b>	<b>California Milk Cows</b>	<b>CA Share of U.S. (%)</b>
1990	10,127	1,135	11.2
1991	9,992	1,155	11.6
1992	9,835	1,158	11.8
1993	9,589	1,210	12.6
1994	9,500	1,235	13.0
1995	9,458	1,254	13.3
1996	9,361	1,264	13.5
1997	9,252	1,389	15.0
1998	9,158	1,401	15.3

**Federal Support Purchases<sup>1</sup> and Supply.** Federal purchases of dairy products through the Commodity Credit Corporation (CCC) are a reflection of general supply conditions. Generally, when supplies are long, CCC purchases are up. When supplies are short, CCC purchases are down. Historic CCC purchases have been highly variable. Relative to total production, total US CCC purchases were large for brief periods in the mid 1950's and early 1960's. CCC purchases from both California and the rest of the US were large for an extended period in the 1980's. In 1983, CCC purchases peaked at 13.2% of total US milk production. Before that time, California did not produce enough manufactured products to have a significant impact on CCC purchases.<sup>2</sup> However for the 1990's, purchases from both California and the rest of the US have been below historic averages and continue to trend downwards. Since 1995, CCC purchases have represented less than 1.0% of total US milk production. As of the date of the hearing, there were no uncommitted federal inventories of butter, nonfat dry milk (NFDM) or Cheddar cheese. (See HE#35.)

## **Demand**

Trends in per capita consumption within California indicate a sluggish demand for fluid milk products. There has been a steady decline in per capita consumption of fluid milk products (whole, 2% lowfat, 1% lowfat, and skim). From 1978 to 1998, annual per capita consumption declined from 31.8 gallons to 22.3 gallons. There were year-to-year declines every year except 1984. (See HE#12, Table 35.)

Unlike fluid milk products, manufactured dairy products have shown strong growth in commercial demand. This is evidenced by the rapid growth California manufacturers have experienced in production of Class 4 dairy products, by robust and volatile prices on the national market for manufactured products, and by the low levels of CCC purchases from California.

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<sup>1</sup>The operations of this program are discussed above in “Section II” under “Federal Milk Support Program” which begins on page 7.

<sup>2</sup>National milk production has increased 33 percent in the last 45 years, while California’s production has increased 322 percent. As a result, California’s share of US production has risen from 5.1 percent in 1950 to 17.5 percent in 1998. See HE#12, Tables 1 and 2.

**UTILIZATION OF POOLED MARKET MILK BY CLASS 1/  
Based on Total Fat plus Solids-Not-Fat Production in California  
1988 – 1998  
(pounds all solids)**

Class 1	Class 2	Class 3	Class 4a	Class 4b	Total Milk Production
-2.8%	+23.1%	+39.5%	+72.7%	+125.3%	+54.3%

1/ See HE#16

On a national basis, commercial disappearance<sup>3</sup> of all dairy products (fluid and manufactured) was up in 1988 and the first six months of 1999. Commercial disappearance is projected to increase again in 2000. (see HE#38.)

### Prices to Consumers

The Department does not have statutory authority to regulate the retail price of milk.<sup>4</sup> However, the Department does maintain and publish data on retail milk prices (see HE#11, Tables 18 and 19). While there is a relationship between changes in the farm and retail price of milk, historically the relationship is much stronger when farm prices are increasing. When farm prices decrease, the price change at retail does not tend to decrease at a corresponding rate. However, recent data suggests that this may no longer be true.

The Departmental data on prices reflects a growing spread between farm prices received by producers and retail prices paid by consumers. The data also reflects a growing spread between the lowest and highest retail price for comparable fluid milk products. Finally, *“the levels of retail prices of milk and milk products paid by consumers are affected by a large number of economic and other factors apart from minimum producer prices for market milk . . . many of which factors are not within the power of the [Department] to regulate or control, particularly since the [repeal] of minimum wholesale and retail prices . . .”* (§61802(h))

### Farm<sup>5</sup> and Commodity Price Relationships

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<sup>3</sup>Commercial disappearance equals beginning inventory plus production less sales to the Commodity Credit Corporation and ending inventory.

<sup>4</sup>Historically, the Department did establish minimum retail prices from 1938 to 1978 when the program was terminated by legislation.

<sup>5</sup>Strictly speaking, the relationship to federal order farm prices belongs below in this section under  
(footnote continued on next page)



## Background

Between 1978 and 1987, national dairy farm prices were extremely stable. The federal support price program cleared the market when production exceeded demand by building federal inventories of butter, nonfat dry milk (NFDM), and cheddar cheese. These federal inventories were available to balance the needs of the commercial market whenever production fell short of demand.

During this period, because of the heavy influence in the marketplace of the relatively high federal, dairy support-price levels, commodity prices were stable from month to month. California farm prices were tied directly to commodity prices, and federal milk marketing order farm prices<sup>6</sup> were tied indirectly to commodity prices. Thus, stable commodity prices resulted in stable California farm prices and in stable, federal-order farm prices.

Since 1987, the decrease in the federal target support price<sup>7</sup> (and the accompanying decrease in support purchase prices for butter, NFDM and cheddar cheese) eliminated the massive federal inventories of butter, NFDM and cheddar cheese. The lower federal inventories of butter, NFDM and cheddar cheese were no longer adequate to stabilize the market by helping to balance seasonal supply and demand. Consequently, whenever the production of butter, NFDM or cheddar cheese have been inadequate to satisfy commercial demand, dairy commodity prices have been quite volatile. This situation has led to volatility, both in California farm prices,<sup>8</sup> and federal-order farm prices.

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**“Other Factors”** which begins on page 18. However, it is easier to discuss in the context of the relationships among California farm prices and national commodity prices.

<sup>6</sup>The federal Class III-A farm price did not exist prior to 1992.

<sup>7</sup>The target support price and the support purchase prices are discussed above in **“Section II”** under **“Federal Milk Support Program”** which begins on page 7.

<sup>8</sup>Actually California Class 1 farm prices were not volatile prior to 1993 because of the use until then of the three factor Class 1 pricing formula. As discussed above in **“Section II”** under **“Pricing Formulas”** which begins on page 6, California’s current one factor Class 1 pricing formula allocates changes in the Commodity Reference Price (CRP) to changes in the three component prices (fat, solids-not-fat, and fluid). However, from 1978 to 1993, a three factor Class 1 pricing formula allocated changes (1) in the CRP, (2) in on farm cost of production and (3) in consumer income, to changes in the three component prices (fat, solids-not-fat, and fluid). Because of the stability in commodity prices prior to 1987, price changes in the three factor formula tended to match price changes in other California and federal regulated milk farm prices keeping California’s Class 1 farm prices in an appropriate relationship with the farm prices of other classes of milk. With the volatile commodity prices since 1987, in order to match the dynamics of the other California farm prices and all federal farm prices, in 1993 the three factor Class 1 pricing formula was replaced by the current one factor Class 1 pricing formula, based only on commodity prices. Since 1993, the current one factor pricing formula has resulted in Class 1 farm prices better matching the dynamics of other California classified farm prices and federal farm prices. This analysis of the old three factor Class 1 pricing formula is support by prior hearing records as referenced in the Statement of Determination resulting from the February 5, 1997 and February 7, 1997 hearings. See HE#47.

## **Current Price Relationships among California Farm Prices, National Commodity Prices, and Federal Order Farm Prices**

Nationally, volatile prices have become the norm. California milk production has increased 9.1% thus far in 1999. In the other 49 states, the increase has been 2.1%. Dairy commodity prices, especially cheese, experienced significant increases in the beginning of the year. Block Cheddar cheese prices skyrocketed up to one of the highest levels on record. This was in part due to misreporting of Cheddar cheese inventories by USDA. The inaccurate numbers created a false demand for dairy commodities. Once revised commodity numbers were announced, commodity prices adjusted to more reasonable prices. Because farm prices are directly or indirectly tied to commodity prices, increasing commodity prices translated into higher farm prices.

Departmental exhibits entered into the hearing record indicate that California's five classified farm prices continue to reflect the moving values of national manufactured dairy products. The California farm prices also maintain an appropriate relationship both among themselves and, apparently, with their corresponding farm prices in federal orders, except for Class 1 farm prices. At several recent hearings (April 21, 1995, December 15, 1995, August 9, 1996, October 8, 1996, February 5, 1997 and February 7, 1997, see HE#43), independent processors and distributors in the Northern California Marketing Area, have documented their competitive disadvantage in competing with packaged milk from processors in Oregon regulated under a federal order; they have contended that they are at a disadvantage because California fluid milk prices are higher than prices in Oregon. The problems with the relationship of California Class 1 farm prices and federal Class I farm prices, and the action taken by the Department is discussed in detail in the "*Statement of Determination and Order . . .*" resulting from the February 5, 1997 and February 7, 1997 hearings (see HE#43(c) and HE#43(b)).

## **Production Cost**

Comparing the twelve months ending June 1998 to the twelve months ending June 1999, the statewide weighted average on farm cost of milk production has decreased \$0.08 per hundredweight (see HE#7 and HE#20).<sup>9</sup> Decreases in feed costs (-\$0.44) were offset by increases in labor (+\$0.06) and miscellaneous costs associated with herd replacement, operations, and marketing (+\$0.25). The cost decreases were in part due to an increase in milk production from 56.4 to 56.8 pounds per cow per day.<sup>10</sup>

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<sup>9</sup>The \$0.08 decrease in production costs must be viewed in terms of changes in producer farm prices. For the same relative time periods, producer farm prices for quota, base and overbase milk increased \$1.84 per hundredweight. See HE#7 and HE#17.

<sup>10</sup>USDA conducts production cost surveys for the six largest dairy regions in the United States. The Department conducts cost of production surveys for the five dairy regions within California. The Department cost of production cannot be directly compared to USDA production costs because different methodologies are used. However, a comparison of USDA production costs in the Pacific Region of Arizona, California and Washington to

(footnote continued on next page)

Production costs are quite variable both within and among the five production cost regions. The following summaries for May and June 1999, the average cost, the ranges of costs and share of the state's total milk production for each of the five regions (see HE#18):

	Average	Low to High	Production Share
Del Norte-Humboldt	\$11.51	\$10.00 to \$14.57	0.8%
North Bay	\$11.98	\$9.82 to \$17.14	3.4%
North Valley	\$11.86	\$9.87 to \$20.37	35.4%
South Valley	\$11.64	\$9.72 to \$15.03	38.3%
Southern California	\$11.34	\$9.48 to \$13.71	22.2%
Whole State	\$11.66	\$9.48 to \$20.37	100%

The plentiful supplies of hay, feed grains, and feeds stuffs, favorable weather conditions for producing milk within California have resulted in relatively low milk production costs compared to prior time periods. Production cost data for the four most recent months (March – June 1999) reflect costs that are comparable to the relatively low levels of the early 1990s.

### Other Factors

In addition to the above, in establishing the provisions of the Stabilization and Pooling Plan, the Department “*shall take into consideration any [other] relevant economic factors*” not specifically listed in the Food and Agricultural Code (§62802(h), §61805(b), §62062, §62076 and §62076(c)).

At several recent hearings (February 17, 1995, December 15, 1995, August 9, 1996, October 4, 1996 and October 8, 1996, see HE#43), there has been testimony regarding the disadvantages that independent fluid processors and distributors in the Northern California Marketing Area are having in competing with packaged milk from Option-Exempt, Producer-Handlers<sup>11</sup> in the South

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the Department's average cost of production for California shows that both have the same pattern of change. Since California produced 77 percent of the milk in the Pacific Region in 1995, a comparison of USDA's production costs in the Pacific Region to production costs in other regions will give a good indication of how competitive California's cost of production is with the rest of the country. Such a comparison shows that for 1994 the Pacific Region production costs averaged \$2.31 less than the lowest cost in any other region. For 1982 through 1994, the these same cost differences ranged from a low of \$1.42 in 1985 to a high of \$2.95 in 1993. This indicates that the Pacific Region, and therefore the state of California, has one of the lowest production costs in the nation, if not the lowest production cost. (See HE#12, HE#17 through HE#20, and HE#39.)

<sup>11</sup>In California, producer-handlers are also referred to as producer-distributors.

Valley. Option-Exempt, Producer-Handlers do not account to the pool for the Class 1 production that is covered by the exempt quota they own (§62708.5). These Option-Exempt, Producer-Handlers received additional advantages beginning in 1994: (1) when the Class 1 farm price was increased; and (2) when they were allowed to exempt additional purchased quota.<sup>12</sup> The problems with the relationship of Northern California and South Valley processors, and the action taken by the Department is discussed in detail in the “*Statement of Determination and Order . . .*” resulting from the October 4 and 8, 1996 hearings (see HE#43).

At two recent hearings, testimony identified shipments of bulk milk into California. At the first hearing (August 9, 1996, see HE#43), testimony focused on the increase in bulk milk imported into California. There was disagreement regarding the cause of this increase. Some cited price differences. Others said there were underlying structural causes. The problems with these price differences, and the temporary action taken by the Department is discussed in detail in the “*Statement of Determination and Order . . .*” resulting from the August 9, 1996 hearings (See HE#43). At the second hearing (October 9, 1996, see HE#43), there was testimony urging “. . . the Department to recommend and effectuate changes to more equitably treat California producers as well as out-of-state producers . . .”<sup>13</sup> and stating that handlers receiving out-of-state milk are “. . . detrimentally affecting the California pool . . .”<sup>14</sup> The Department took no action on these issues at that time as discussed in detail in the “*Statement of Determination and Order . . .*” resulting from the October 9, 1996 hearings (see HE#43).

### Equity<sup>15</sup>

The Pooling Plan for Market Milk is established under the authority of Chapter 3, Part 3, Division 21 of the Food and Agricultural Code. The title of Chapter 3 is “Equalization Pools”. The words equalize, equalized, equalization and equitable all appear at the beginning of Chapter 3 in Sections 62702 and 62702.1. However, while the Code does speak of **equity** the Code does not provide for **equal** prices to all producers. Within the constraints of the Quota/Overbase system, the Department seeks to treat all producers marketing milk in California evenhandedly and as fairly as possible consistent with the public policies enacted by the legislature when considering changes to the Stabilization Plans and the Pooling Plan.

Both Chapter 2 (Stabilization Plans) and Chapter 3 (Pooling Plan) also address equity issues among processors. Section 61805(b) states that classified prices should attempt to but are not required to result in uniform costs for all processors in a marketing area. Section 62720 states that

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<sup>12</sup>See Attachment A-4.

<sup>13</sup>The quote is from the bottom of page 5 of HE#48 from the October 9, 1996 hearing. See HE#43.

<sup>14</sup>The quote is from the bottom of page 13 of HE#48 from the October 9, 1996 hearing. See HE#43.

<sup>15</sup>equity (èk'wî-tê) noun. The state, quality, or ideal of being just, impartial, and **fair**. [Middle English equite, from Old French, from Latin aequitâs, from aequus, even, **fair**.] The American Heritage Dictionary of the English Language, Third Edition is licensed from Houghton Mifflin Company. Copyright © 1992 by Houghton Mifflin Company. All rights reserved.

pooling plans shall result in uniform costs for all processors in a marketing area. The two sections are not in conflict. Section 61805(b) acknowledges that processors with plants in different marketing areas with different prices, may compete to some extent in the same marketing area.<sup>16</sup> However, Section 62720 requires that the Pool Plan insure that every processor within the same marketing area have the same raw product costs for milk components.

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<sup>16</sup>Competition among processors in different marketing areas may lead to market area consolidation. See the discussion of marketing areas above in “**Section II**” under “**Marketing Areas**” which begins on page 7.

## **SECTION V PROPOSALS AND TESTIMONY<sup>17</sup>**

### **SUMMARY OF TESTIMONY**

#### ***Dairy Institute of California (Institute) – Dr. William Schiek, Economist***

Dr. Schiek stated that the Department’s review of Class 1 pricing was warranted for three reasons:

1. While Congress may make change to USDA’s Final Rule, the basic pricing structure is known with a “fairly high degree of certainty”.
2. There is continuing price misalignment between farm prices in California and in adjacent markets.
3. Price misalignment is exacerbated when viewed on a component basis. California undervalues milk fat and overvalues solids-not-fat compared to federal order prices in neighboring states.

The Institute anticipated that a series of hearings might be necessary to bring California’s pricing into long-term alignment with federal order pricing in adjacent states. Dr. Schiek stated that, waiting until all uncertainties are eliminated is not viable because of the significant misalignment that currently exists.

Dr. Schiek argued that changes in the competitive environment make Class 1 price alignment more crucial now than a few years ago. These changes include:

- Greater numbers of regional and national milk processing and retailing companies
- Greater potential for interstate marketing of milk and dairy products
- Changes in transportation infrastructure and logistics systems for large food retailers

With these changes, Dr. Schiek stated that milk could be moved greater distances when significant price differences exist.

Dr. Schiek provided evidence (summarized below) to support the Institute’s conclusion that California’s current formulas do a better job at achieving price alignment during periods of relatively stable prices, but perform much worse when prices are volatile. He stated that, in the current environment, prices would remain volatile.

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<sup>17</sup> Attachment A-1 summarizes the positions of all interested parties.

Difference in Class 1 Prices Between  
California Markets and Markets in Neighboring States

<b>Period</b>	<i>So CA less Las Vegas</i>	<i>So CA less Phoenix</i>	<i>No CA less Portland</i>
<i>June 97 to Present:</i>	\$0.95	\$0.03	\$0.38
<i>June 98 to Present:</i>	\$1.19	\$0.27	\$0.62

Dr. Schiek stated that during this past year, the dairy industry experienced substantially more volatile milk prices compared to the previous year. He concluded that California's pricing formulas were further misaligned this past year because of the increased volatility.

Dr. Schiek stated that the impending changes in the federal order system will both reduce Class I differentials in Oregon and Arizona and significantly change the Class I price mover. His prognosis was that the reformed federal system would increase the existing misalignment between California's Class 1 minimum prices and those in neighboring states. He said this misalignment would be even more significant when looking at month to month variations and when looking at price comparisons on a component basis.

*The Institute's Proposals:*

1. The current Class 1 base value system makes it impossible for California's minimum prices to track well with those in neighboring states. The Institute proposed that this value system be abandoned.
2. To better align with federal order prices in neighboring states, California should adopt a Commodity Reference Price (CRP) that is based upon the "higher of" either a cheese-whey butter milk value or a butter-powder milk value. This same value basis is proposed for the reformed federal system. Class 1 component prices would be based directly off this CRP, with fat prices being determined directly from butter prices and skim claiming the residual value from the hundredweight price. The skim milk value would then be apportioned to nonfat solids and fluid based upon the recent historical ratio of nonfat solids to fluid carrier in skim milk.
3. An appropriate Class 1 differential would be added to the Class 1 mover to achieve reasonable alignment with prices in neighboring markets. "Reasonable" is defined by the Institute as being as close to prices in neighboring states as possible for each of the major Class 1 products (whole, reduced-fat, lowfat and skim). The Institute proposed differentials of \$1.265 for Northern California and \$1.535 for Southern California.
4. Class 1 prices would be calculated monthly.

5. A more current commodity price window for use in the pricing formulas that would most closely mimic the values reported in the NASS survey:
  - a. Simple weekly average of CME Cheddar block and barrel prices for the two week period beginning as of the first Friday falling on or after the 25<sup>th</sup> day of the second prior month. Block prices would be weighted by 0.37 and barrel prices (plus three cents) would be weighted by 0.63.
  - b. Simple weekly average of CME Grade AA butter prices for the two week period beginning as of the most recent Friday falling on or before the 9<sup>th</sup> day of the prior month.
  - c. Weighted average of the most current two weekly California Extra Grade and Grade A nonfat dry milk prices as of the Friday falling on or before the 9<sup>th</sup> day of the prior month.
6. The Class 1 mover milk values would be determined from the above commodity price average using the manufacturing cost allowances and yields in the existing CRP and Class 4a pricing formulas.

According to the Institute's analysis, its proposal would have brought California's prices to within a range of -1.7 cents to +2.2 cents difference from neighboring states on the four milks in the two Marketing Areas over the past 12 months.

Dr. Schiek stated that the Institute opposes the Western United proposal because it does not go far enough to bring California's prices into "reasonable" alignment with those in neighboring states, particularly on a component basis.

***Western United Dairymen (Western United) - Jay Goold, Executive Vice President***

Western United proposed short-term adjustments to the Stabilization Plans that they feel would bring the Stabilization Plans into compliance with the "reasonable relationship" provision in § 62062.1 of the Food and Agricultural Code.

Mr. Goold stated two arguments for short-term adjustments. First, Western United feels that there is no statutory or regulatory mandate that "reasonable relationship" be interpreted to mean a zero difference between California Class 1 prices and federal order Class I prices in neighboring states as proposed by the Institute. Secondly, challenges to USDA's Final Rule continue both in Congress and in the courts. Given the possibility of changes in and/or postponement of the Final Rule, Western United does not feel longer-term changes to the Stabilization Plans are warranted.

Western United proposed that temporary changes be implemented for the period November 1, 1999, through February 29, 2000, at which time another hearing could be called. During this period, Western United proposed that prices be calculated and announced on a monthly basis.



Mr. Goold stated that those proposing a longer-term solution are motivated solely by an attempt to “grab additional producer dollars” [emphasis added]. He also stated that current criticism of milk prices is focused on retail prices that may or may not change as a result of this hearing.

Western United proposed a shortened, more current time period for collection of commodity price data. It proposed that the Department use commodity prices announced for the period from the 26<sup>th</sup> of the second prior month through the 10<sup>th</sup> of the prior month.

#### ***Land O’ Lakes – Dr. James Gruebele, Consultant***

Dr. Gruebele introduced a proposal for temporary changes to the Stabilization Plans from his client, Land O’ Lakes, Inc. Its proposal would:

1. Calculate and announce Class 1 prices monthly.
2. Use a two-week period that is one week earlier than the NASS survey period for collection of commodity pricing data used in the California formula.

Dr. Gruebele introduced a series of tables analyzing the difference in minimum farm prices between Southern California and the Phoenix market and Northern California and the Portland markets under the various scenarios under consideration. His analysis also included a measure of the variation in price differences arguing that under the Land O’ Lakes proposal, this variation is minimized.

Dr. Gruebele concluded by recommending the Department appoint an industry committee to study the California Class 1 pricing formula including the price relationships for lowfat milks. He said the committee should also look at the pool impacts of changes in the component prices.

#### ***The Alliance of Western Milk Producers (Alliance) - Jim Tillison, Executive Vice President, CEO***

The Alliance was unequivocally in feeling that the Department’s call of the hearing was premature. While federal order reform was scheduled to be implemented on October 1, Mr. Tillison stated that legislation is being debated in both houses of Congress that could significantly changes federal order Class 1 prices in neighboring states. He stated that the Phoenix order differential would be between 70 to 92 cents higher under Option 1a, the pricing system proposed in Congress. Mr. Tillison also referred to the court cases challenging USDA’s Final Rule.

Mr. Tillison stated that, “Any substantial, long term change in how milk is priced should be the result of an industry consensus, if possible.” He said that, in the past, significant changes have been preceded by meetings of representatives of the various industry segments to try to agree on

the direction changes should take. He also stated that when changes are contemplated for the Class 1 pricing formula, the Department must also consider the potential impact on other class prices, the relationship between prices, and the impact on the Pool.

The Alliance proposes temporary minor changes to the Class 1 pricing system:

1. Prices should be calculated and announced on a monthly basis. Whether or not federal order reform is implemented, monthly price calculations would bring California into better alignment with federal order prices.
2. The period during which the Department collects price data for cheese, butter and nonfat powder should precede those USDA has set for NASS survey prices by one week. Because the prices for Cheddar cheese and butter announced by the CME directly affect the NASS survey prices, the Alliance proposes the Department use the CME prices that best match the NASS survey prices.
3. If federal reform is implemented, the Class 1 pricing formula should use the higher of a butter/powder or a cheese CRP. Mr. Tillison stated that using the “higher of” CRP will enhance alignment with prices in neighboring states. He presented an analysis supporting this conclusion. However, if federal reform is not implemented, the CRP should be cheese based only.

Mr. Tillison presented testimony regarding the definition of “reasonable”. He stated the Institute’s definition was rejected by the Alliance for the following three reasons:

1. The Institute proposal switches the neighboring market comparisons from Northern California – Medford, Oregon and Southern California – Las Vegas to Northern California – Portland and Southern California – Phoenix. Mr. Tillison stated that threats to close plants in Medford and Las Vegas if federal order reform is implemented are not a sufficient basis for dismissing these markets from the analysis.
2. The volumes of milk that are imported into and exported from California does not support an argument that California prices are not in reasonable relationship to neighboring states.
3. The Department’s analysis failed to consider the cost of transporting milk across state lines. He stated that his membership checked the price of hauling milk from Phoenix to Los Angeles and it amounted to about 18 cents per gallon.

***Stremics Heritage Foods, LLC - Ed Gassmann, Vice President of Finance***

Mr. Gassmann stated that his firm produces both fresh milk and Extended Shelf Life (ESL) products. He said that his firm ships its fresh milk products through most of California and that its ESL products are shipped to most Western, Midwest, South Western states and as far away as Japan. He stated that in August, 30% of the raw milk received by his firm was used in products

shipped out of the Southern California market and that it is projected this percentage will double by the end of the year.

Mr. Gassmann emphasized that markets for fresh fluid milk, particularly ESL milk products, are no longer local. He stated that differences in compositional standards is bad enough but that differences in regulated raw products costs make it possible for processors across the nation to compete in the California market.

Mr. Gassmann stated that the cost to transport milk from Phoenix to Southern California was less than eight cents per gallon. The cost to transport milk from Southern California to Phoenix is sixteen cents per gallon because there is little demand for back hauls from Phoenix. He stated that in addition to the freight difference there are also mandatory compensatory payments to federal Market Administrators. Differences in component prices and over-order premiums also add to the competitive disadvantage faced by California processors.

Mr. Gassmann stated that Stremics Heritage Foods supported the Institute proposal.

***Humboldt Creamery Association - Rich Ghilarducci, CEO***

Mr. Ghilarducci stated that Humboldt Creamery Association opposes any change in the Stabilization Plans because of this hearing for the following reasons:

1. The uncertainty surrounding federal order reform.
2. Even with over-order premiums, the additional cost of transporting milk from federal orders into California causes the current formula to be in reasonable alignment with neighboring federal orders.
3. Bi-monthly pricing gives the California dairy industry a marketing advantage. Price changes are disliked by consumers. Because our prices change once every two months, Mr. Ghilarducci argued that California's pricing system provides more stability.

***Crystal Cream and Butter Company (Crystal) - Sharon Hale, Vice President***

Ms. Hale stated that competition is becoming more concentrated and intense every year. She stated that the rate of consolidations in recent years within the dairy processing, cooperative and retail industries has dramatically increased the level of competition. She stated that the Department should be aiming at a pricing system that produces as little difference as possible in California prices as compared to those in neighboring states. She stated that the price comparison should be considered not only on whole milk, but also on all of the major fluid milk products. She stated that this is especially important when bidding on school contracts where 1% lowfat milk is the primary product.

Ms. Hale testified that Crystal continues to support bimonthly pricing because of the increase in labor cost and confusion for customers that would result with monthly pricing. She stated that monthly price changes would be particularly hard for distributors to administer because they lack the automation and expertise that major processors possess.

Ms. Hale also testified in support of continuing to use the CME prices in calculating the Class 1 price. She stated that the additional lead-time that using the CME prices would provide is critical to Crystal in getting price change information out to their customers. She also stated that with the uncertainty surrounding California's compositional standards, the Department should stand ready to hold additional hearings to review Class 1 prices.

Except for not wanting to change from bimonthly to monthly pricing, Ms. Hale stated that Crystal supported the Institute proposal.

***Milk Producers Council - Geoffrey Vanden Heuvel***

Mr. Vanden Heuvel stated that Milk Producers Council objected to the call of the hearing. He referred to a letter submitted by its legal counsel in which the authority of the Department to call the hearing was challenged. He stated that the call of the hearing was improperly based upon § 62062.1 and was without the benefit of a petition. He argued that a hearing referencing § 62062.1 was too late based on a review of 1998 prices, and too early based on a review of 1999 prices.

Mr. Vanden Heuvel also stated that the hearing was premature given the uncertainty of federal order reform. He referred to legislation being debated in Congress and the court challenges being pursued. He stated that the hearing should be closed without any changes to the pricing formula or continued until such time that a legal basis for a hearing under § 62062.1 exists.

Mr. Vanden Heuvel raised concerns about procedural issues related to the hearing. He stated that Milk Producers Council believes the Department should not consider any new information submitted in post-hearing briefs. He also raised concerns about ex parte communications. He noted that a statement in one document included in the Department's analysis of proposals represents "*inappropriate discussion of the merits of the hearing issues.*"

**LETTERS SUBMITTED PRIOR TO THE CLOSE OF THE HEARING**

***Security Milk Producers (Security) - Karen Brooks, General Manager***

Security stated that it believes California prices are in reasonable relationship to neighboring states and attached a historical comparison of prices in Southern California to Phoenix to support

its conclusion. Ms. Brooks also stated that the hearing was premature given the uncertainty over the outcome of federal order reform.

***Dairy Farmers of America (DFA) - David L. Parrish, Vice President, COO***

DFA wrote that it supported the testimony presented by the Alliance. However, its letter included a proposal that differed in one respect from the Alliance's proposal; DFA placed no conditions on adopting a "higher of" CRP. DFA proposed:

1. Monthly pricing.
2. The CRP should be based on the higher of a butter/powder mover and a cheese/Grade B butter mover, regardless of whether federal order reform is implemented.
3. CME prices for butter and cheese should be those for the two-week period that is one week earlier than the two-week period for the NASS survey.
4. The period used for the California weighted-average powder price should be for the two consecutive Fridays after the 26<sup>th</sup> of the second previous month.

DFA also recommended the appointment of an industry committee to study the entire Class 1 pricing program.

***Clifford & Brown - David R. Albers***

Mr. Albers, writing as legal counsel for Milk Producers Council, presented his case that the Department's call of a hearing was not authorized.

***Knox, Lemmon & Anapolsky - John M. Lemmon***

Mr. Lemmon submitted a letter as legal counsel for the Institute rebutting the argument made above by David Albers on behalf of Milk Producers Council.

***Driftwood Dairy - James E. Dolan***

Driftwood Dairy stated its support for the Institute proposal with the exception of monthly pricing. Mr. Dolan's letter raised the issue of school milk contracts that reference bimonthly price changes.

***Super Store Industries (SSI) - John D. Kaczor, Director***

SSI stated its support for the Institute proposal. Mr. Kaczor stated SSI's concern regarding a continuing competitive inequity that he hopes will be addressed as a result of this hearing.

***National Farmers Organization, Inc. (NFO) - Francis Pacheco, Pacific Regional Director***

NFO supported the position of Milk Producers Council that the Department should not have called the hearing. Mr. Pacheco cited a flaw in the Institute's proposal that should have disqualified it and therefore should have canceled the hearing process.

***California Dairy Campaign (CDC) - Frank Faria, President***

It is unclear whether CDC's letter was authored by Mr. Magnuson, as stated on page 1 or by Mr. Faria, as stated on page 2. However, CDC's position was that the only change that should be made is to calculate and announce Class 1 prices on a monthly basis. However, they did say that the existing base price should be increased to reflect the cost of production.

**POST HEARING BRIEFS**

***Consumer***

Mrs. Patricia J. Lastufka opposed milk price increases and felt that milk prices are generally too high.

***Dairy Institute of California (Institute)***

The Institute supported incremental changes in the Class 1 pricing formulas regardless of the uncertainty surrounding federal order reform. Dr. Schiek cited the five-year competitive disadvantage California processors have faced because of California's higher Class 1 prices as compared to those in neighboring markets. He stated that to continue to wait for the outcome of federal order reform would be detrimental to California's milk processors.

Dr. Schiek argued that the Department should take initial steps because of the September 21 hearing to address the existing misalignment in prices regarding Class 1 fat and skim. Additional hearings can be held once the reformed federal order system is established.

The Institute stated that moving to monthly pricing alone is not sufficient to bring California's prices into reasonable relationship with those in neighboring states. While several witnesses testified regarding the improved alignment of California's prices to those in neighboring states, California prices would continue to be higher than in neighboring states.

The Institute argued that the Class 1 base value system should be abandoned in favor of a variation of the federal order fat-skim Class 1 pricing.

The Institute proposed changes based upon three different scenarios:

1. As long as the current (pre-reform) federal order system is in place, California's Class 1 pricing formulas should be changed as follows.
  - a. Eliminate the use of and reference to Class 1 base values.
  - b. Continue to use the current CRP as the Class 1 hundredweight mover.
  - c. Add an appropriate differential to attain hundredweight alignment with Medford and Las Vegas.
  - d. Price Class 1 fat directly from the butter market as originally proposed.
  - e. Class 1 skim would be priced as the residual of the CRP price after the fat value is removed.
  - f. Apportion the skim value to nonfat solids and fluid in the manner described in the original proposal.
2. If federal order reform is implemented except with Option 1-A differentials, then adopt the Institute's original proposal with an increase in the Class 1 differentials of 40 cents per hundredweight to align prices with those in Medford and Las Vegas.
3. If federal order reform is implemented according to USDA's Final Rule, then adopt the changes put forth in the Institute's original proposal.

Dr. Schiek spoke to the appropriate markets that are most competitive with California's processors. Depending on the differentials that are used, the markets with the lower differentials are the most competitive. Under existing (pre-reform) and under Option 1-A differentials, Las Vegas and Medford have the more competitive raw product costs and are therefore better able to compete with California processors. Under USDA's Final Rule (modified Option 1-B) differentials, Phoenix and Portland have the most competitive raw product costs.

Dr. Schiek argued that California's prices should be no greater than those in neighboring states for the following reasons:

1. The need to restore California processors' competitiveness within California's borders.
2. Increases in California over-order premiums.
3. Lower freight costs for product moving into California.
4. Greater ability for product to move longer distances.
5. California milk production growth.
6. Decreases in California milk production costs and feed costs.
7. Decreases in California Class 1 milk consumption.

Dr. Schiek expanded on his hearing testimony regarding the use of barrel Cheddar cheese prices in the CRP. He stated that barrel cheese processors have been disadvantaged in the market place because their raw product costs were determined by the block Cheddar cheese market while their processed product was sold at the barrel price. USDA determined in its Final Rule that including the barrel prices provided a better representation of the cheese market. Dr. Schiek also argued that by including barrel prices, California's pricing would be in better alignment with federal order pricing because barrel prices will be included in federal order formulas.

In response to one witness' claim that the CME is considering the termination of cash trading on barrels, Dr. Schiek stated that the Institute had contacted CME and was told that no such consideration exists.

Dr. Schiek expanded upon his testimony regarding the use of manufacturing allowances in the CRP formula. He stated that the Institute proposed this for two reasons, because they are to be used in the federal system and to maintain a reasonable relationship among the Class prices. Since manufacturing allowances are used in the Class 4a and 4b formulas, they should be used in the Class 1 formula. Dr. Schiek stated that this would require the Department to reexamine the Class 1 pricing formulas each time changes were made to the Class 4 formulas. However, he stated that if the Department found this to be too burdensome, it would be possible to construct a CRP formula similar to the Institute's proposal without the manufacturing allowance provided the differentials were adjusted accordingly.

### ***Super Store Industries***

Mr. Kaczor stated that the Institute's proposal effectively eliminates the competitive disadvantage California processors have faced in retaining their in-state customer base and reduced the barrier to California processors attempts to expand their markets into neighboring states.

Mr. Kaczor stated that California producers continue to argue that the relatively small volume of packaged product that moves into California from other states is evidence of reasonable price alignment. He stated this argument fails to consider the competitive actions California processors must take to prevent the loss of markets.

Mr. Kaczor commented on the argument that the difference in prices between California and neighboring states cannot be targeted to be zero because the Code does not mandate a zero difference. He argued that economic theory would provide for California prices that are lower than those in neighboring states by the amount of transportation costs differentials. He argues that, *"Simply stated, prices for agricultural commodities are lowest in the areas where supplies are greatest."*



Mr. Kaczor also argued that California should include the barrel Cheddar cheese price in its Class 1 formula. He stated that USDA was rightly concerned about a repetition of the misrepresentation of milk values the M-W Grade B price series created as the quantities of Grade B milk dwindled.

### ***The Alliance of Western Milk Producers (Alliance)***

Mr. Tillison argued that the delay in implementation of federal order reform would result in federal order prices for October and November that are in reasonable relationship to California's prices. He also argues that California's prices will drop significantly on December 1 and that price alignment will be maintained accordingly. The Alliance's position is that with the court's restraining order against USDA, no changes are warranted in California's Class 1 pricing formulas.

Mr. Tillison cited as evidence of reasonable price alignment the fact that Stremics Heritage Foods has greatly expanded its market for ESL products. He also argued that Mr. Gassman's claim about the difference in haul rates to and from Southern California was not accurate.

### ***California Dairy Campaign (CDC)***

CDC filed a post hearing brief to certify that the position taken in advance of the hearing had been approved by its Board of Directors. Mr. Faria also stated that CDC supported the position of Milk Producers Council.

### ***Crystal Cream & Butter Company (Crystal)***

Ms. Hale submitted a post-hearing brief clarifying Crystal's position regarding reasonable relationships between California milk prices and those in competing markets. She stated that Crystal's position is not that there should be a zero difference in prices every month, but that over time the difference in price should close to zero.

Ms. Hale concluded by saying that price relationships between Oregon and California have not been in a reasonable relationship since 1995. To address this misalignment, the Department will need to do more than adopt monthly pricing.

Attachment A-2 summarizes the witnesses proposals and their impacts on processor prices and producer revenues.

**SECTION VI**  
**REVIEW OF PREVIOUS HEARINGS**  
**Regarding Class 1 Pricing Formula and the CRP Formula**

**August 2, 1990**

A hearing was called to consider changes to the Class 1 pricing formula. Two changes were made as a result of the hearing. First, value was shifted from fat (decreased by \$0.1430 per pound) to SNF (increased by \$0.0424 per pound) and fluid (increased by \$0.0015 per pound). Second, the CRP was made a temporary snubber for the Class 1 pricing formula during the period October 1, 1990 through January 1, 1991.

**March 31, 1993**

This hearing was convened to consider alternatives to the Class 1, 2 and 3 pricing formulas. The changes were made to the Class 1 pricing formula. First, for the 14-month period June 1993 through July 1994, the current Class 1 pricing formula was replaced by the formula using only the CRP. Second, the CRP was permanently altered by the inclusion of Grade B (whey) butter price and yield factors. Third, value was shifted from fat (decreased by \$0.1428 per pound) to SNF (increased by \$0.0230 per pound) and fluid (increased by \$0.0023 per pound). No changes were made to the Class 2 and 3 pricing formulas.

**September 30, 1993**

As a result of a hearing held September 30, 1993, to consider alternatives to the current Class 1, 2, and 3 farm pricing formulas, the following changes were made. Two changes were made to the Class 1 pricing formula. First, the current Class 1 farm pricing formula was permanently replaced by a formula using only the CRP. Second, a base price increase of approximately \$0.84 per hundredweight was combined with shift from fat (decreased by \$0.1428 per pound) to SNF (increased by \$0.0569) and fluid (increased by \$0.0096). The Class 2 and 3 differentials were increased \$0.01 per pound for fat and \$0.02 for SNF for a combined increase of \$0.21 per hundredweight.

**April 21, 1995**

As a result of the hearing, a temporary \$0.13 per hundredweight increase in the Class 1, 2, 3, 4a and 4b prices was established. The increase was a fixed \$0.0107 per pound of both fat and SNF. The temporary increase was operational from June 1995 through January 1996.

**August 9, 1996**

This hearing addressed the issue of milk price alignment using surrounding states as references. The Department determined that California Class 1 price was too high relative to other adjoining states and was encouraging importation of out-of-state milk into California. The Class 1 pricing formula was revised by calculating the CRP in a different manner. For the 6-month period October 1996 through March 1997 the CRP was the simple arithmetic mean of the two alternative calculation methods — Cheddar cheese & whey butter or butter & NFDM.

### **February 5 and 7, 1997**

These two hearings were held to address milk price alignment with other states. The following changes were made to correct the misalignment.

1. Class 1 prices were frozen at the February/March 1997 level for the April/May 1997 pricing period;
2. CRP in the future will be based on Cheddar cheese prices;
3. CRP will be based on a single (current) month;
4. Shift value from SNF back to fat;
5. Reduce the value of the fluid component in the Class 1 price;
6. Shift value from fat to fluid component in the Southern California Marketing Area.

### **April 21, 1997**

The National Cheese Exchange (NCE) was being terminated, and a cheese exchange was being established at the Chicago Mercantile Exchange (CME). The old pricing formulas for both the Class 4b price and the CRP used NCE cheese prices. As a result of this hearing, both formulas now reference CME cheese prices.

### **May 8, 1998**

The CME announced that it would no longer trade Grade B butter at the Exchange. A hearing was held to consider the best indicator of the value of whey butter. As a result of the hearing, the CRP formula uses the simple average CME Grade AA butter price less ten cents (\$0.10).

## **SECTION VII**

### **ANALYSIS OF THE HEARING RECORD**

Dairy processors favored adjustments in the Class 1 pricing formula that reduce the cost of unprocessed milk and make California fluid products more competitive with products brought into the California by out-of-state processors. The pricing proposals submitted by Dairy Institute, if adopted through the hearing process would have resulted in some reduction in the Class 1 price level for the month of November. Some dairy farmer representatives objected to the call of the hearing. They opposed making any changes to the Class 1 pricing formula. Citing section 62062.1 of the Food and Agricultural Code, they argued that the section requires a hearing only when the prior calendar years weighted average price was not reasonably related to the Class 1 price in neighboring states and that the Department had not made such a determination.

However, the Food and Agricultural Code grants the Secretary broad discretion to call hearings and make amendments to the pricing formulas as necessary. The Secretary is not limited to the authority cited in Section 62062.1. Notwithstanding Section 62062.1, Section 62032 of the Code gives the Secretary broad discretion to call a hearing based on his own motion. Section 62031 authorizes the Secretary to amend or terminate any stabilization and marketing plan after notice and public hearings, if the Secretary finds that the plan is no longer in conformity with the standards which are prescribed in the statutes. These two sections are independent of each other. Neither is a precondition for implementation of the other. Section 62032 gives the Secretary discretion in his or her administration of the Plans, while Section 62062.1 mandates a public hearing when certain conditions exist. Additionally, the Department recognizes the merits of the letter submitted by John Lemmon on September 20, 1999. See HE#50.

Some producer representatives did testify in support of amending the Class 1 price formula by adoption of monthly rather than bimonthly pricing for a limited time period. Several producer groups who favored monthly pricing also supported amendments to the pricing formula that would incorporate the higher value of cheese or butter/powder as the commodity reference price factor rather than using only the value of cheese as the Commodity Reference price factor. Still other producers supported the adoption of a more current period for reflecting commodity prices in the Class 1 pricing formula.

During the brief filing period, between September 27 and October 1, it became widely known that a federal court had stopped implementation of federal milk marketing order reform. Several witnesses modified their positions in their post hearing briefs while noting federal court's action to prevent implementation.

When the 1996 Farm Bill (Federal Agriculture Improvement and Reform Act) was enacted it mandated that the 31 federal milk marketing orders be consolidated into 10-14 orders and that the USDA evaluate marketing and pricing reforms in the federal milk marketing order system. It quickly became apparent that USDA would conduct a thorough evaluation of the federal order's

milk pricing system and major structural changes might be implemented as a result. USDA was mandated by Congress to implement reform by April 1, 1999.

Having held hearings on February 5, and 7, 1997, to consider price alignment issues in accordance with Section 62062.1, it was the Department's belief that it would be prudent to wait until federal reform was implemented prior to considering substantive changes. When Congress extended the implementation date to October 1, 1999, the Department again felt it would be prudent to wait until federal order implementation.

However, it has become increasingly apparent that federal order reform is controversial and may take years of litigation and Congressional debate before any conclusive action is taken.

More importantly, in the last two years the commodity markets for manufactured dairy products have experienced tremendous degrees of price volatility. The spread between the high price and low price during the 1998 and 1999 for a 40-pound block of cheese was the largest it has ever been over the past 9 years. Additionally, the spread between the high and low Class 1 farm price for a gallon of fluid milk was about 50 cents a gallon, the largest amount in the past 9 years. The price volatility in the 90s have been much higher than the those experienced in the 1970s and 1980s and do adversely impact the competitive position of California fluid milk products.

With the continued roller coaster of farm milk pricing it has become necessary to address some of the more important fundamental issues with California Class 1 pricing formula. In evaluating the issues raised at the hearing it is appropriate to consider only those pricing issues that are fundamental problems and to weed out for later consideration those issues that are more related to federal order reform. In doing so, the Department must consider the long-term public interests, balancing the competing interests of producer, processors, retailers, and consumers. It is the department's objective to develop public policy that serves the long-term public interests.

### **Federal Order Reforms**

There was much discussion regarding federal Class I pricing in adjacent states. Some argued not to base California Class 1 pricing on comparisons with the current federal orders. Instead, they argued, it would be wise to see what the new federal order program will be like before making changes to the California program. However, California's hearing process is much quicker than the federal process. California can make adjustments warranted by current conditions and can make further adjustments if federal order reform is implemented.

The timing and scope of federal order reform is uncertain. Therefore, what is important is not what federal orders *may do*; it is what federal orders *are doing* currently. The following characteristics of current federal Class I pricing in adjacent states are relevant to these hearings:

- Minimum Class 1 Prices are announced monthly;

- Prices are announced on a Fat/Skim Basis
- Prices are based upon the BFP plus a differential;
- The BFP moves primarily with cheese prices;
- The Class 1 differentials for adjacent states are:
  - \$1.50 for SW Idaho-E Oregon (at Boise);
  - \$1.60 for Great Basin (at Las Vegas);
  - \$1.82 for Pacific Northwest (at Medford);
  - \$1.90 for Pacific Northwest (at Portland); and
  - \$2.52 for Central Arizona (at Phoenix).

### **Calculation and Announcement of Class 1 Prices on a Monthly vs. Bimonthly Basis**

#### ***Issue:***

Since the adoption of formula-driven minimum farm pricing for Class 1 dairy products in California, prices have been calculated and announced every two months. Currently, these formulas are based upon a Commodity Reference price for the second prior month. For those regions of the nation regulated by federal milk marketing orders, prices are calculated and announced on a monthly basis. This has led to significant periodic differences in regulated fluid milk farm prices between California and neighboring states.

#### ***Proposal:***

The Dairy Institute of California (Institute) proposed a change to monthly calculation and announcement of regulated Class 1 minimum farm prices.

#### ***Analysis:***

In prior hearings on the Class 1 pricing formulas, producer representatives have supported adoption of monthly Class 1 price calculations. However, processor representatives have opposed the adoption, testifying that they have been willing to cope with these brief differences in farm prices because the benefits of bimonthly prices to processors and consumers outweigh the better monthly alignment with out-of-state competitors on raw product costs.

By calculating prices monthly, alignment with prices in the current federal order system is significantly enhanced from month to month and marginally enhanced on a long-term basis. Because of the degree of price volatility was smaller in those periods, and the possibility that federal orders might have switched to bimonthly pricing under federal order reform, the Department had determined in prior hearings that the maintenance of bimonthly pricing was appropriate.

However, it is clear that whatever form federal order pricing takes as a result of the reform process, monthly pricing will remain in effect for federal orders for the foreseeable future. This is not an issue being debated either in Congress or in the courts.

As the federal government has lowered price supports for dairy commodities over the past three years, the volatility of farm milk prices has dramatically increased in response to relatively small changes in market conditions for dairy products. California has experienced significant monthly differences in the movement of farm milk prices compared to those in neighboring states (see Attachment A-3).

There is no question that adoption of monthly Class 1 pricing better aligns California's prices with those Class 1 prices most other states in the nation. Moreover the increased degree of price volatility provides more justification for adoption of the monthly price calculation.

The increased volatility of the dairy commodity prices has occasionally distorted the relationship between California's Class 1 price and its Class 4b price, due to the difference in pricing periods of the two pricing formulas. Monthly calculation of Class 1 farm prices would result in better alignment with monthly Class 4b prices.

Processors and distributors that operate in federal milk marketing order are able to routinely manage their subsequent pricing lists to their customers. There is no evidence in the hearing record that would indicate that California firms could not also successfully manage this aspect of their business.

The benefits of better alignment of California's regulated Class 1 minimum farm prices with most states in the nation and with California's Class 4b farm prices outweighs the added costs to California processors and distributors to change their product price lists.

While the Department also recognizes the increased potential for the "retail ratchet effect" to increase prices to consumers, this phenomenon should be diminished by the increased scrutiny of California retail milk prices through the Department's implementation of the Consumer Milk Price survey on January 1, 2000.

Since 1979, wholesale and retail prices for milk have not been regulated other than one law that prohibits a wholesaler or retailer from selling milk at a price that is lower than their cost to sell the product. In 1975, when wholesale and retail prices were regulated by the State, the farm price made up 61 percent of the retail price for milk. In 1999, in an unregulated market, the farm price only makes up 44 percent of the retail price for milk. See Attachment A-4.

A change to monthly pricing in California would put California processors, distributors and consumers on par with those in regions regulated under federal milk marketing orders.

***Determination:***

The adoption of monthly calculation and announcement of Class 1 minimum farm prices is appropriate.

### **Changing to Fat Pricing based on Butter Prices and SNF/Fluid Pricing as a Residual**

#### ***Issue:***

Generally, regulated milk prices directly or indirectly use the price of butter to determine the price of fat for the various classes of milk. This is true for all federal order fat prices and for all California fat prices except the California Class 1 fat price. As long as butter prices are not volatile, it is possible to adjust Class 1 fat prices incrementally through hearings to maintain a reasonable relationship both with fat prices for other California classes and with federal Class I fat prices.

#### ***Proposal:***

At the hearing, the Dairy Institute of California (Institute) proposed basing the Class 1 fat price on the price of butter. The SNF and fluid prices would be established as residuals. This proposal is summarized in Attachment A-5. This was the only concept presented at this hearing dealing with this issue. However, at the hearing in March 1993, a proposal had been made that would also have based the fat price on the butter price with the SNF and fluid prices established as residuals (HE#4/31-III-93).

#### ***Analysis:***

Attachment A-6 compares two series of butter prices: (1) the federal support purchase price (SPP) for butter; and (2) the Chicago Mercantile Exchange (CME) Grade AA butter price. From 1983 to 1994, the SPP was reduced from \$1.49 to \$0.65 per pound. The CME price ranged from \$0.65 to \$1.60, but never more than \$0.17 per pound above the support purchase price. As the result of four hearings held October 1989, August 1990, March and September 1993, \$2.05 per hundredweight was shifted from fat to SNF and fluid. Because the SPP price declines were gradual and were tracked closely by the CME price, the hearing process was able to ensure that the California Class 1 fat price maintained a reasonable relationship with other fat prices, especially the federal Class I fat price.

Since 1994, there have been dramatic changes in the butter markets. From 1995 to present, the support purchase price for butter has remained at \$0.65 per pound. However, the CME AA butter price ranged from \$0.65 to \$2.71, as much as \$2.06 per pound above the support purchase price. As a result, in 1998 San Francisco whole milk prices averaged \$0.30 per hundredweight above the Portland price, while lowfat averaged \$1.02 above. With declining butter prices in the first 10



months of 1999, whole milk prices have averaged \$0.79 per hundredweight above the Portland price, while lowfat averaged only \$0.57 above. Because CME prices have become so volatile, it is no longer feasible through the hearing process to make timely adjustments to the Class 1 fat price to maintain a reasonable relationship with the federal Class I fat price

Any proposal that ties Class 1 fat prices to butter generally results in better alignment with reduced fat products in adjacent states. California processors may be better able to compete with out-of-state reduced fat products.

However, such a proposal could result in lowfat products having a higher price than whole milk, thus encouraging consumers to drink a higher fat product. In addition, the Institute's specific proposal would result in different SNF prices and thus different NFDM fortification allowances in the two marketing areas.

The current Class 1 farm price changes with changes in the Commodity Reference Price (CRP). Changes in the CRP are allocated to changes in the three component prices: fat, SNF, and fluid carrier. Forty percent of the change is allocated to fat, 40 percent to SNF and 20 percent to fluid. These changes in the fat, SNF and fluid components are added, respectively, to base prices for the fat, SNF and fluid components. There are no explicit differentials between the Class 1 farm price and the CRP; however, there are implicit, computed differentials: \$0.79 per hundredweight in Northern California and \$1.06 in Southern California.

In order to keep better alignment with other fat prices, the Department has determined that Class 1 fat prices will be based on butter prices by modifying the proposal of the Dairy Institute (see Attachment A-5). The modifications keep the standard representative tests for California milk: 3.5% fat, 8.7% SNF and 87.8% fluid and results in a simple whole milk price value equal to the CRP plus a specific differential. Finally, a uniform NFDM fortification allowance will be maintained. Only the fluid component prices will differ between the two areas by the current \$0.0031 per pound (27.2¢ per hundredweight).

### ***Determinations:***

Under the new Class 1 pricing formula, there will be explicit differentials between the Class 1 farm price and the CRP. As discussed in the following section on price levels, the Northern California price will equal the CRP plus \$0.222 per hundredweight and the Southern California price will equal the CRP plus \$0.494 per hundredweight. The fat price will be directly tied to the CME butter by a formula:

$$\text{Class 1 fat price} = (\text{CME butter price} - \$0.045 - \$0.097) \times 1.2$$

The SNF and fluid prices will be based on the residual of the hundredweight price less the value assigned to the fat, for example in Southern California:

$$\text{Residual} = (\text{CRP} + \$0.494) - (3.5 \times \text{Fat Price})$$

$$\text{SNF Price} = 76\% \times \text{Residual} \div 8.7$$

$$\text{Fluid Price} = 24\% \times \text{Residual} \div 87.8$$

### **Changing to a Two Week Window for Commodities**

#### ***Issue:***

One aspect of the federal order final rule was to change the existing time frame used to compute commodity prices in the federal order system. Currently in federal orders, the BFP from the second prior month was used to establish Class I prices. The final rule uses the most current two-week period available by the 23<sup>rd</sup> of the prior month. This was an attempt to move to a more current method of pricing commodities. Currently, the California pricing system uses the commodity prices from the 26<sup>th</sup> of the third prior month to the 25<sup>th</sup> of the second prior month as the time frame for determining the Class 1 price.

#### ***Proposal:***

There were three proposals that offered different options to changing the existing time frames. The first proposal uses the simple average of the daily trading or sales falling between the 26<sup>th</sup> of the second prior month to the 10<sup>th</sup> of the prior current month for all three commodities (butter, non-fat-dry milk and cheese). The second proposal uses the simple average of the weekly averages that are one week earlier than the two-week NASS-USDA period used by AMS-USDA for all three commodities. The third proposal uses a simple average of weekly averages that have different time frames for each commodity.

#### ***Analysis:***

The proposal to change the existing time frame for commodity prices was an attempt to better align with the movement of prices in adjacent states. This change would also keep Class 1 prices in better alignment with the Class 4b prices.

While the proposed new time frame would allow prices to track better with the federal order system, it would not fully reflect the activity of the commodity markets. It would also shorten the advance notice to processors of price changes.

#### ***Determination:***

With the unresolved status of USDA's Final Rule and no definite timeline for implementation, it would be more appropriate to reconsider this issue after federal order reform is implemented.

### **Alternatives Affecting California's Commodity Reference Price**

#### ***Issue:***

As dairy commodity markets continue to be volatile, the differences between the California Class 1 and FMMO Class I pricing formulas have become more apparent. In USDA's final decision for federal milk marketing order (FMMO) reform, the new Class I pricing formula will contain manufacturing cost allowances and references to the barrel Cheddar cheese price. Furthermore, the Class I price will incorporate a "higher of" concept that, in effect, selects either a cheese-based price mover or a butter and nonfat dry milk-based price mover. The inclusion of the three elements in the pricing formula may contribute toward continued disparities in minimum regulated fluid milk prices in California and in FMMOs.

#### ***Proposal:***

Changes were proposed to the Class 1 formula that would add manufacturing cost allowances, include Chicago Mercantile Exchange barrel Cheddar cheese prices, and select between either a cheese-based or a butter and nonfat dry milk-based price mover, whichever is higher.

#### ***Analysis:***

In carrying out the directive of the 1996 Federal Agriculture Improvement and Reform Act, USDA announced fundamental changes in the mechanism for pricing milk to be used for fluid purposes. The Class I pricing formula released in USDA's final decision contains manufacturing cost allowances, references to the barrel Cheddar cheese price, and a "higher of" concept that, in effect, selects either a cheese-based or a butter and nonfat dry milk-based price mover. While USDA's reform package has yet to be implemented, these factors will likely exacerbate price differences realized under the current pricing formulas.

CDFA and FMMOs use different formulas to establish minimum prices for milk assigned to fluid uses. With the release of USDA's new Class I pricing formula, the Department has an opportunity to evaluate price levels and movements obtained from the two fluid milk pricing formulas.

The proposal suggests changes to California's commodity reference price (CRP) that attempt to mimic or copy USDA's Class I pricing formula in its reform package. The principal reason for

adding manufacturing cost allowances and using the "higher of" approach appears to be entirely based on improving the degree to which California Class 1 prices would move with FMMO reform milk prices. The inclusion of barrel Cheddar cheese prices in the CRP would add more price information related to Cheddar cheese transactions.

However, the Department notes a number of drawbacks to adopting the proposal. First, because of similarities in the pricing formulas, adding manufacturing cost allowances to the CRP may imply that changes to the Class 4b pricing formula necessitate identical changes to the Class 1 pricing formula. Second, the addition of Cheddar barrel prices to the CRP would "water down" the impact of Cheddar block prices on the Class 1 price. Such a change appears to be inconsistent with industry practice of using only the 40 pound block Cheddar cheese price as an index for determining a price in many types of cheese transactions. Third, by reworking the current CRP, it is possible to better align the California Class 1 price with Class I prices in surrounding markets without the addition of more factors to the pricing formula. Fourth, the impetus for the proposed changes to the CRP appear to be driven almost entirely by the Class I pricing formula changes announced in USDA's final decision. However, at this date, implementation of the FMMO reform package remains unresolved with no definite timeline describing when the changes might take effect. Last, incorporating a mechanism that selects between either a cheese-based or a butter and nonfat dry milk-based price mover, whichever is higher, will tend to raise milk prices. At a time of already high milk prices, low feed prices, and rapid increases in milk production, such a change in the Class 1 pricing formula appears to be inconsistent with the Department's role in regulating milk prices.

***Determination:***

The manufacturing cost allowances, barrel Cheddar cheese prices and the "higher of" concept for a price mover will not be included in the CRP at this time. With the status of USDA's Final Rule unresolved and no definite timeline for implementation, it may be more appropriate to reconsider these issues *after* federal order reform is implemented.

## **Price Level**

***Issue:***

Dairy processors have testified at recent hearings that California's regulated Class 1 minimum farm prices have placed them at a competitive disadvantage with processors in neighboring states. California's Class 1 prices have recently averaged higher than those in neighboring states.

Dairy producer representatives have testified at these same hearings that having prices that are higher in California does not necessarily mean that California's prices are not in a reasonable relationship to those in neighboring states. They argue that these higher prices are needed for

Class 1 utilization to generate its share of revenues to the pool. It is incumbent upon the Department to determine what policy best serves the public interest.

***Proposals:***

There were three basic proposals presented at the hearing regarding the Class 1 price levels. One would have resulted in an increase in the Class 1 price of \$0.73 per hundredweight. The second would have resulted in no change and the third would have resulted in a decrease in the Class 1 price of \$0.46 per hundredweight.

***Analysis:***

*Production Costs and Milk Prices*

Over the last two years economic conditions facing dairy farmers have been favorable. With plentiful supplies of grain and feed, milk production costs throughout the nation have been quite reasonable. Relatively good weather conditions in 1999 combined with the ample supplies of low cost feeds have been particularly beneficial to the California dairy industry. California milk production costs in 1999 are running near the lowest levels achieved in the last 10 years.

Although volatile, minimum farm milk prices have been quite positive. In 1998, the average California farm milk price was about \$15.00 per hundredweight. This was approximately \$2.64 per hundredweight more than the previous four-year average and about \$1.50 per hundredweight higher than the highest annual average over the previous four-year period. While USDA and many dairy experts were forecasting lower farm milk prices in 1999, strong cheese sales have resulted in strong average milk prices thus far. To date, the average California milk price is \$13.68 per hundredweight, which also exceeds the annual average price during the years 1994, 1995, 1996, and 1997.

*Production and Production Capability*

California led all other states in total annual milk production with over 27.6 billion pounds in 1998. It produces over 5 billion pounds more milk than second leading state, Wisconsin. California's total production is nearly 2.4 times larger than the third and fourth leading dairy states (New York and Pennsylvania).

California has not only led the nation in total milk production since 1994, it has been consistently among the top states for having the largest rate of production increases. More importantly, the annual rate of production increase has been accelerating this year. In August 1999, California lead the nation in its monthly production increase over the same month in the prior year with an increase of about +14.6 percent (about 331 million pounds). This is the largest annual increase from one month to the same month in the prior year in the past 45 years. California's production between

January to August 1999 is currently about 9.4 % above the same period for 1998 period. There is no reason to believe that 1999 production levels won't continue to increase at high levels. It appears that 1999 may go down as the largest annual increase in milk production.

As detailed in Section IV, between 1990 to 1998 California milk production has increased 32 percent, or a 4% annual average. A four- percent annual increase on 27.6 billion pounds of milk production (1998) represents over 1.1 billion pounds of milk production. To put this annual production increase in perspective, it represents:

- 41 percent of Arizona's total 1998 production (2.68 billion pounds).
- Over 2.25 times Nevada's total 1998 annual production (466 million pounds).
- Approximately 70 percent of Oregon's total 1998 production (1.583 billion pounds).

The steady increase in total cow numbers over the past nine years indicate that the production increases are not driven solely by favorable weather and good dairy management. The California dairy industry's investment in additional cows, the fundamental resource needed to produce milk, is a strong indication that these trends will continue.

California's increasing rate of milk production and the increasing number of cows both strongly suggest that there are ample economic incentives to produce more milk. Since Class 4a and 4b prices are among the lowest in the nation, and Class 2 and 3 usage represent a lower percentage of total milk usage, it is reasonable to conclude that the current Class 1 prices levels provide some of existing incentives to produce more milk.

As California's share of the national supply grows ever larger, its increasing rate of annual production increase can dramatically affect the delicate balance between the national milk supply and commercial demand.

#### *California Exports and Imports of Unprocessed and Packaged Milk*

The Department's data on packaged milk products entering and exiting the California are estimates. Import data are provided quarterly via voluntary reports for the purposes of collecting specific sanitation fees from out of state processors or distributors who market packaged milk products in California. Export data are provided in monthly voluntary reports by California milk processors. The available data indicate that sales of packaged products brought into the state have not increased. However, California fluid milk processors have consistently questioned the accuracy of the import data in their testimony at various hearings. A variety of Northern California processor representatives have testified that larger geographic regions of Northern California are subject to out-of-state competition. They have testified that the lower farm milk prices in other states give out of state processors a competitive advantage in the Northern California market.

The data on unprocessed milk brought into California is more reliable. California fluid milk plants on a monthly basis generally report the information along with their other unprocessed milk

purchases. The data indicates that the importation of unprocessed milk has been increasing over time as evident in the following table:

Importation of Unprocessed Milk into California  
For Selected Years

<b>Selected Years</b>	<b>Volume (1000 lbs.)</b>	<b>% Increase from Jan-July 98</b>
1994	254,733,000	
1997	643,351,000	
1998	540,893,000	
1999 Jan-July	370,933,000	22.4%

While the total quantities dropped in 1998 from the previous year, 1998 imports were double the volume imported into the state in 1994. Moreover, in the first 7 months of 1999, 22.4 % more volume was imported into the state than the same period in 1998. If the remainder of 1999 is projected forward using the same rate of 22.4% increase, then 1999 will result in over 662 million pounds of imported unprocessed milk.

Departmental records reflect that the unprocessed milk being imported into California is being used primarily for fluid purposes (i.e., Class 1). Based on this information it appears that the California Class 1 farm price attracts increasing volumes of unprocessed milk from out-of-state areas.

#### Utilization

Despite strong promotional efforts to increase the consumption of fluid milk and other dairy products, the sales of Class 1, 2, 3 products have been relatively flat for several decades (see Attachment A-7). California's increased milk production has exceeded increases in the sales of Class 1, 2, 3 products.

Consequently, as the California dairy industry has become the leader in milk production, it has become one of the nation's leading suppliers of manufactured products (Class 4a and 4b). It also routinely supplies manufacturing plants in other states substantial quantities of basic milk components- cream, condensed skim milk.

It is important to understand that Class 4 usage (cheese, butter, and powder) generally receives among the lowest farm milk prices. Class 4 products are traded nationally and must be competitively priced since much of California's products must be shipped thousands of miles to states in the Midwest, south, and along the East Coast.

It is troublesome that increased amounts of unprocessed milk flows into California's fluid milk plants from out-of-state sources, while an increasing proportion of California's milk supply is being used in the lowest valued milk classes. It would be more efficient to use as much of California's production as possible in Class 1 products, thus reducing unneeded transportation costs from distant farms.

More competitively priced Class 1 milk in California will encourage its use both in California fluid uses and in fluid milk uses in surrounding states.

### *Federal Order Reform and the Cornell Model*

In determining the Class 1 differentials contained in the final federal rule, USDA relied primarily on a Cornell University economic study which evaluated the available milk supply regions and the spatial dispersion of milk and dairy product consumption. The Cornell group used a large spatial equilibrium economic model (U.S Dairy Sector Simulator or USDSS) that included data for every county within the continental United States. The data reflected:

- grade A and grade B milk production;
- the number and location of fluid, soft product, frozen product, cheese, and butter powder plants;
- the distance from the production areas to each processing plant and consumption center;
- the cost of moving milk and dairy products;
- and the demand for dairy products in the consumption centers.

The economic theory on which the model is based suggests that major milk producing regions such as California and the upper Midwest should have lower Class I prices than other parts of the U.S. The results of the model support what seems economically intuitive, i.e., California's price for fluid milk should be among the lowest in the U.S. The Department concurs with the economic rationale demonstrated by the USDSS model.

USDA's issuance of its final rule to implement federal milk marketing order reform incorporated the relative price surface contained in the USDSS model. While the Class I prices it adopted are not identical to the model results, the relative price differences were maintained.

In issuing its final rule, USDA stated:

“Establishing a national Class 1 price structure based on results from the U.S. Dairy Sector Simulator (USDSS) model, developed and administered by Cornell University, may increase market efficiencies in the dairy industry and lowering the differential (Class 1 price levels) would allow marketing conditions to have a greater impact on actual Class 1 prices paid to producers who serve the Class 1 market”.



After reviewing the public comments and updating market data USDA stated that it:

“... adopted a Class 1 price structure that provides greater structural efficiencies in the assembly and shipment of milk and dairy products. The adopted Class 1 pricing structure establishes a price surface that utilizes USDSS model results adjusted for all known plant locations and establishes differential levels that will result in prices that generate sufficient revenue to assure an adequate supply of milk.”

While the legal challenges have stopped the implementation of federal order reform, the academic validity of the study's determinations on the price surface for Class 1 products throughout the nation have wide support from economists, and others with knowledge of national dairy markets.

### Competitiveness

Over the course of this hearing and previous Class 1 pricing hearings Northern California processors have provided substantial documentation to the degree that the current Northern California Class 1 farm prices have placed them at a competitive disadvantage relative to Class 1 products from Oregon processors. Processors have provided testimony as to the geographic distribution that Oregon fluid milk products are being marketed in Northern California. Departmental hearing exhibits document that California Class 1 prices have placed Northern California processors at a competitive disadvantage beginning in 1997 through 1998 and into 1999.

To a lesser degree, testimony and evidence suggested that processors operating in Southern California faced similar competitive problems in some areas.

### ***Determination:***

Given the above analysis, an adjustment to California's Class 1 pricing formula which would reduce the Class 1 price level is both necessary and warranted. A 57 cent per hundredweight reduction in the base price of the Class 1 formula for whole milk would make California fluid milk products more competitive with other milk supplies and would address the competitiveness issues raised in the above analysis.

### **Summation**

The Department has determined to make three amendments to the Milk Stabilization and Marketing Plans for both Northern and Southern California:

1. To change to monthly calculation and announcement of Class 1 minimum farm prices.
2. A 57-cent per hundredweight reduction in the base Class 1 price used in the formula.

3. To base Class 1 fat prices on butter prices and have the whole milk hundredweight Class 1 farm price equal to the CRP plus a specific differential with the SNF and fluid carrier prices based upon the hundredweight price less the fat price.

The effects of the Department's determinations on parties affected by the milk pricing system, averaged over the period 1995 to 1999 are as follows:

Producers:

Averaged over 1995 to 1999, pool blend prices would have decreased an average of \$0.16 per hundredweight, with annual averages ranging from no change to a reduction of \$0.35 per hundredweight. The effect would be less in a dynamic analysis to the extent that some lost Class 1 sales would have been recovered.

Processors:

Average raw product costs for whole milk would have been down \$0.58 per hundredweight with annual averages ranging from \$0.42 to \$0.82 per hundredweight. All processors will have an improved competitive situation compared to out-of-state processors. Also, processors may see increased sales as a result of improved competitiveness.

Consumers:

Consumers may have seen lower milk prices averaging 4.9 cents per gallon (if wholesalers passed on all farm price reductions), with annual averages ranging from 3.6 cents to 7.1 cents per gallon.

Public:

There will be a general public benefit from having milk prices more responsive to current market conditions.

This \$0.57 (2.9 percent) base price reduction, which is significant, will likely be considered unjustly large by some and irrationally timid by others. The State's adequate milk supplies and rising production trends support a decrease of this amount.

A decrease of this size will also keep California farm price levels within a comparable range to farm prices paid in surrounding states which continue to price milk under pre-reform USDA rules due to federal court injunctions.

**SECTION VIII**  
**FINDINGS OF THE DEPARTMENT OF FOOD AND AGRICULTURE**

The Department of Food and Agriculture makes the following findings based upon the testimony and evidence presented at the public hearing held on September 21, 1999 in Sacramento, California.

All testimony and evidence submitted by all parties to this proceeding, whether specifically mentioned herein, have been considered in rendering these findings. All provisions and declarations set forth in Chapters 2 and 3, Part 3, Division 21 of the Food and Agricultural Code, whether specifically mentioned herein, have been considered in rendering these findings. These include, without exception, all provisions and declarations regarding public interest considerations.

It is hereby found and concluded that:

- (1) The current Stabilization and Marketing Plans for Market Milk now in effect are no longer in conformity with the standards prescribed in and will not tend to effectuate the purposes of said Chapters 2 and 3.
- (2) The amendments presented in Attachments A-8 and A-9 shall become effective as of 12:01 a.m. on November 1, 1999.
- (3) The above referenced changes included in the Stabilization Plans for Market Milk will tend to accomplish the purposes of said Chapters 2 and 3 within the standards therein prescribed.

**SECTION IX**  
**ORDER OF THE SECRETARY OF FOOD AND AGRICULTURE**

Therefore, I order that the Stabilization and Marketing Plan for Market Milk for Northern California Order Number 39, and the Stabilization and Marketing Plan for Market Milk for Southern California Order Number 54, all as amended in Section VIII, shall become effective at 12:01 a.m., November 1, 1999.

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A. J. Yates, Deputy Secretary  
California Department of Food and Agriculture

Signed and entered in  
the Office of the Secretary  
of Food and Agriculture at  
Sacramento, California,  
on October 21, 1999

### *Attachments*

- A-1 Support and Opposition to Proposals
- A-2 Analysis of Alternative Proposals for Pricing Class 1 Milk in California
- A-3 Current Pricing Formula
  - (3a) Whole Milk Prices, California Current Bimonthly Formula and Federal Old Rule, October 1998 to December 1999
  - (3b) Fluid Milk Prices, San Francisco's Current Bimonthly Formula less Portland Old Rule, January 1990 to October 1999
- A-4 Whole Milk Prices, Los Angeles, Farm and Retail, January 1975 to July 1999
- A-5 Alternative Component Allocations
- A-6 Butter Prices, Federal Support Purchase Prices (SPP) and Chicago Mercantile Exchange Prices (CME), January 1970 to August 1999
- A-7 Utilization Of Pooled Market Milk by Class, Total Annual Solids, California, 1978 to 1998
- A-8 Stabilization and Marketing Plan For Market Milk for the Northern California Marketing Area, as Amended, Effective November 1, 1999, by Order Number Thirty-Nine (39).
- A-9 Stabilization and Marketing Plan For Market Milk for the Southern California Marketing Area, as Amended, Effective November 1, 1999, by Order Number Fifty-Four (54).

***Attachment A-1:***  
**SUPPORT AND OPPOSITION TO PROPOSALS**

**Monthly Calculation and Announcement of Class 1 Prices**

**Those in Support:**

Dairy Institute of California  
Western United Dairymen – for the period November through February  
Land O’ Lakes  
*Alliance of Western Milk Producers* – Support withdrawn in post hearing brief  
Stremics Heritage Foods, LLC  
Dairy Farmers of America  
Super Store Industries  
*California Dairy Campaign* – Support apparently withdrawn in post hearing brief

**Those in Opposition:**

Humboldt Creamery Association – *Implicit in that they opposed any changes*  
Crystal Cream & Butter Company  
Milk Producers Council – *Implicit in that they opposed any changes*  
Security Milk Producers – *Implicit in that they opposed any changes*  
Driftwood Dairy  
*California Dairy Campaign* – *Implicit in that they opposed any changes in their post hearing brief*  
*Alliance of Western Milk Producers* – *Implicit in that they opposed any changes in their post hearing brief*  
National Farmers Organization – *Implicit in that they opposed any changes*

**COMMODITY REFERENCE PRICE:**  
**HIGHER OF BUTTER/POWDER OR CHEESE/BUTTER**

**Those in Support:**

*Dairy Institute of California* – Support withdrawn temporarily in post-hearing brief.  
*Alliance of Western Milk Producers* – Support withdrawn in post-hearing brief.  
Stremics Heritage Foods, LLC  
Crystal Cream & Butter Company  
Driftwood Dairy  
Super Store Industries  
Dairy Farmers of America

**Those in Opposition:**

Western United Dairymen – *Implicit in that they did not support*  
Land O’ Lakes  
Humboldt Creamery Association – *Implicit in that they opposed any changes*  
Milk Producers Council – *Implicit in that they opposed any changes*  
Security Milk Producers – *Implicit in that they opposed any changes*  
California Dairy Campaign – *Implicit in that they opposed any changes*  
Alliance of Western Milk Producers – *Implicit in that they opposed any changes in their post hearing brief*  
National Farmers Organization – *Implicit in that they opposed any changes*

### **MORE CURRENT COMMODITY PRICE PERIOD**

#### **Those in Support:**

Dairy Institute – Complex variety of periods that best predict NASS survey prices  
Western United Dairymen – Use prices from 26<sup>th</sup> through 10<sup>th</sup>  
Land O’ Lakes – Two week period, one week earlier than NASS survey  
*Alliance of Western Milk Producers - Two week period, one week earlier than NASS – Support withdrawn in post-hearing brief.*  
Stremics Heritage Foods – Supports Dairy Institute  
Crystal Cream & Butter Company – Supports Dairy Institute  
Driftwood Dairy – Supports Dairy Institute  
Super Store Industries – Supports Dairy Institute  
DFA - Two week period, one week earlier than NASS survey

#### **Those in Opposition:**

Humboldt Creamery Association - *Implicit in that they opposed any changes*  
Milk Producers Council - *Implicit in that they opposed any changes*  
Security Milk Producers - *Implicit in that they opposed any changes*  
California Dairy Campaign – *Implicit in that they opposed any changes*  
Alliance of Western Milk Producers – *Implicit in that they opposed any changes in their post hearing brief*

### **MAKE PRICE ADJUSTMENTS + ESTABLISH CLASS 1 DIFFERENTIALS, SWITCH TO FAT/SKIM BASIS & PRICE MOVER WITH MAKE ALLOWANCE**

#### **Those in Support:**

Dairy Institute – Price difference as close to zero based upon composition of milks *based upon a comparison of NC to Portland and SC to Phoenix* – Changed in post hearing brief to temporarily compare NC to Medford and SC to Las Vegas  
Stremics Heritage Foods – Supports Dairy Institute Proposal  
Crystal Cream and Butter Company – Supports Dairy Institute proposal  
Driftwood Dairy – Supports Dairy Institute Proposal  
California Dairy Campaign – Increase base prices to reflect cost of production – Support withdrawn in post hearing brief

#### **Those in Opposition:**

Western United Dairymen

Land O' Lakes

Alliance of Western Milk Producers

Humboldt Creamery Association – *Implicit in that the opposed any changes*

Milk Producers Council - *Implicit in that the opposed any changes*

Security Milk Producers - *Implicit in that the opposed any changes*

Dairy Farmers of America

California Dairy Campaign – *Implicit in that they opposed any changes in their post hearing brief*



*Attachment A-2:*

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**ANALYSIS OF ALTERNATIVE PROPOSALS  
FOR PRICING CLASS 1 MILK IN CALIFORNIA**

This analysis examines alternatives to pricing Class 1 milk in California. Seven alternatives are examined. The first six were presented at the September 21, 1999 hearing. The last proposal is from the Hearing Panel Report dated October 6, 1999.

- (1) Actual Historic Prices. These are the actual prices published monthly by the Department. They include the 5¢ PSTF charge which is not used in any other analysis.
  - (2) Current Formula: These are prices that would have resulted if the current Class 1, 2, 3, 4a and 4b formulas had been in place in the past.
  - (3) The proposals of the Dairy Institute of California and Crystal Cream and Butter Company. This departs from current pricing by establishing a hundredweight price set as specific differentials above the CRP. It also includes use of two-week advanced commodity prices for the CRP, a higher of CRP; fat prices tied to butter prices and SNF & fluid prices established as a residual. The differentials proposed are \$1.265 for Northern California and \$1.535 for Southern California.
    - (3a) Monthly pricing (Institute)
    - (3b) Bimonthly pricing (Crystal)
  - (4) The proposal of Western United Dairymen, Alliance of Western Milk Producers, Land o' Lakes, and Dairy Farmers of America. No change in the base fat, SNF and fluid prices. Monthly pricing. Two-week advanced commodity prices for the CRP.
    - (4a) Cheese only CRP (Western, LOL and conditionally Alliance)
    - (4b) Higher of CRP (DFA and conditionally Alliance)
  - (5) Recommendation of the Hearing Panel. This is similar to (3a) in that it departs from current pricing by establishing a hundredweight price set as specific differentials above the CRP. It also includes monthly pricing, fat prices tied to butter prices with SNF and fluid prices established as residuals. The differentials proposed are \$0.222 for Northern California and \$0.494 for Southern California.
-

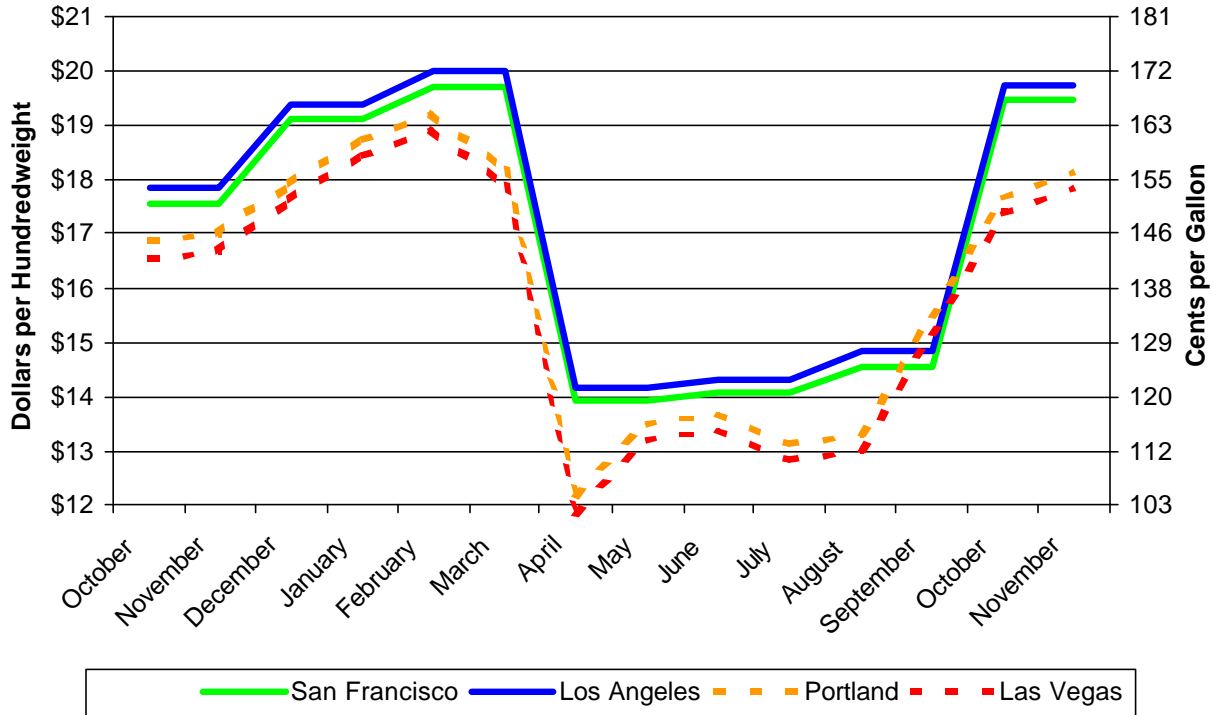
## SUMMARY OF ALTERNATIVE CLASS 1 FORMULA PROPOSALS<sup>1</sup>

				IMPACT: JAN '95 TO SEP '99 (OCT '98 TO SEP '99 for federal comparisons)			
				CLASS 1 CHANGE FROM CURRENT		POOL CHANGE FROM CURRENT	Calif. Ave. less AZ-OR Ave.
				@ 3.5%, 8.7%	@ 2.2%, 9.6%	@ 3.5%, 8.7%	@ 3.5%, 8.7%
	<u>Frequency</u>	<u>Base Prices</u>	<u>Commodity Reference Price</u>				
(1) Actual Historic Prices	Bimonthly	Variable	Variable including three factor formula	\$0.23	\$0.32	\$0.07	\$0.42
(2) Current Formula	Bimonthly	Unchanged	Cheese/Whey Butter	\$0.00	\$0.00	\$0.00	\$0.38
(3a) Institute Proposal	Monthly	none	Hundredweight price equals higher of 2-week CRP + \$1.265 or \$1.535 differentials, 27¢ spread between North and South, Class 1 fat price set equal to an advanced 2-week Class 4a fat price, Class 1 SNF and Fluid prices are determined as residuals	-\$0.46	-\$0.56	-\$0.14	-\$0.01
(3b) Crystal Proposal	Bimonthly	none	Hundredweight price equals higher of 2-week CRP + \$1.265 or \$1.535 differentials, 27¢ spread between North and South, Class 1 fat price set equal to an advanced 2-week Class 4a fat price, Class 1 SNF and Fluid prices are determined as residuals	-\$0.47	-\$0.57	-\$0.15	\$0.00
(4a) Western-Alliance- LOL Proposal	Monthly	Unchanged	Cheese/Whey Butter only using a 2-week window	\$0.08	\$0.06	\$0.02	\$0.45
(4b) Alliance-DFA Proposal	Monthly	Unchanged	Higher of Butter/NFDM or Cheese/Whey Butter using a 2-week window	\$0.73	\$0.63	\$0.15	\$1.23
(5) Panel Recommendation	Monthly	none	Hundredweight price equals CRP + \$0.222 or \$0.494, 27¢ spread between North and South, Class 1 fat price set equal to Class 4a fat price, Class 1 SNF and fluid prices are determined as residuals	-\$0.58	-\$0.63	-\$0.16	N/A

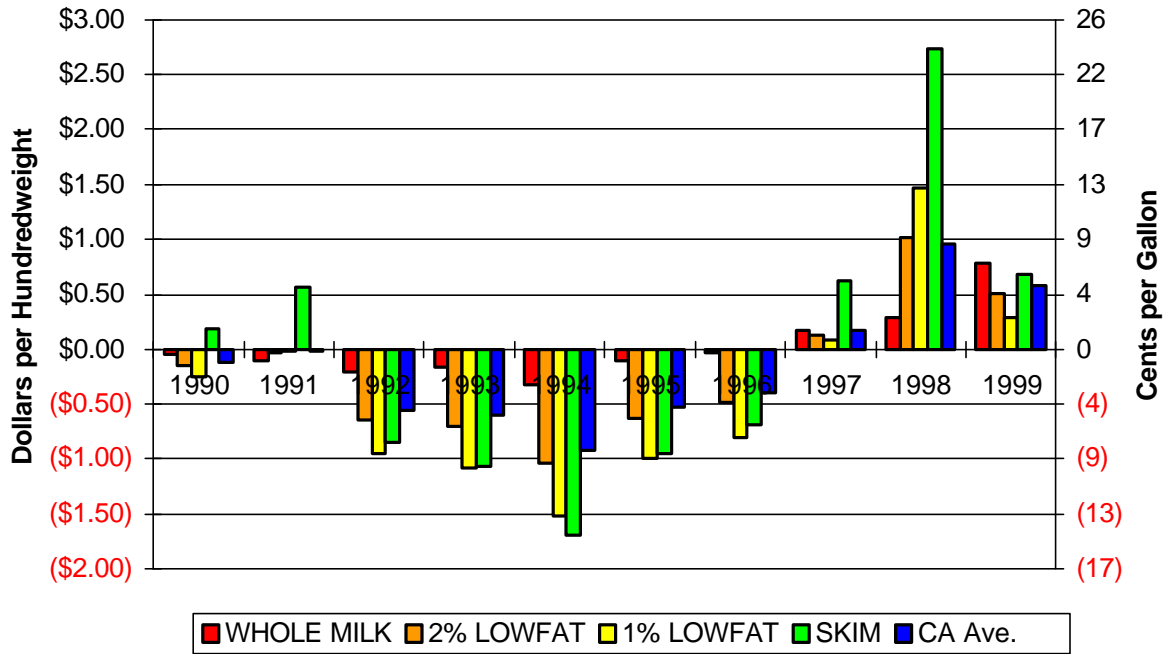
<sup>1</sup>This differs from previous summaries in that it includes average impacts for the five year period January 1995 to September 1999. Comparisons with the new federal orders are still for October 1998 to September 1999.

Attachment A-3:

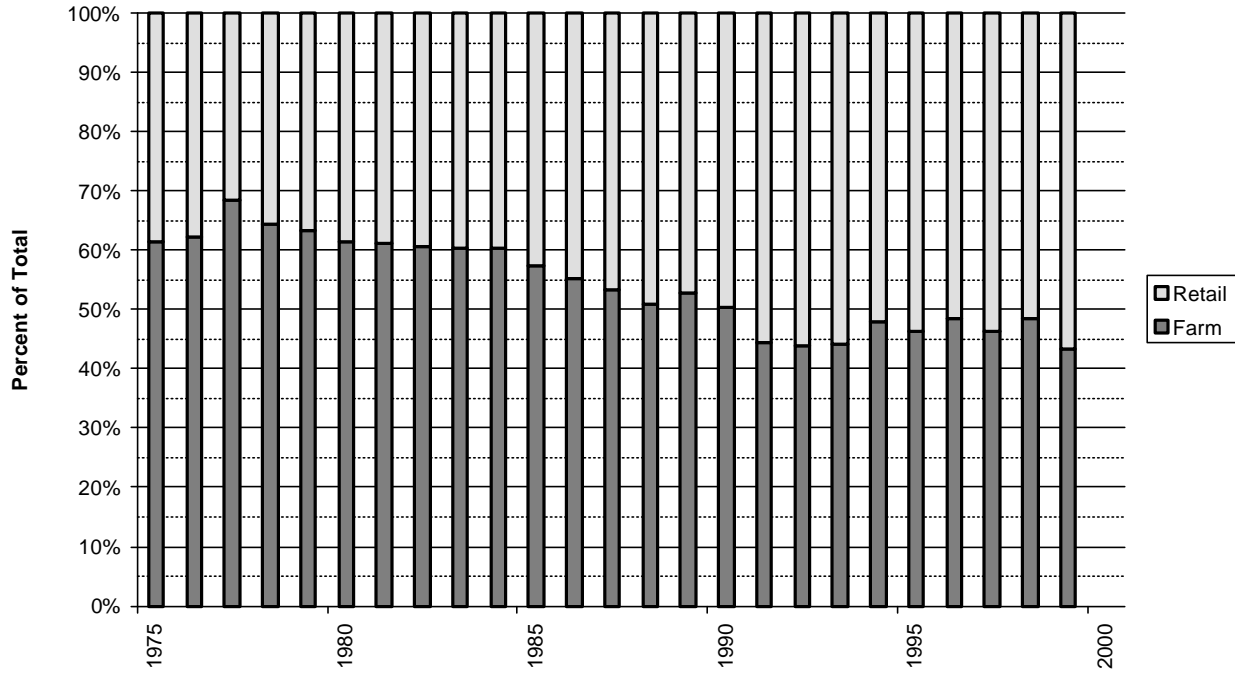
**(3a) CURRENT PRICING FORMULA  
WHOLE MILK PRICES  
California Current Bimonthly Formula  
and Federal Old Rule, October 1998 to November 1999**



**(3b) CURRENT PRICING FORMULA  
FLUID MILK PRICES  
San Francisco's Current Bimonthly Formula  
less Portland Old Rule, January 1990 to October 1999**



*Attachment A-4:*  
**WHOLE MILK PRICES**  
 Los Angeles, Farm and Retail, January 1975 to July 1999



**Attachment A-5:**  
**Alternative Component Allocations**

Dairy Institute of California's Proposal

Southern California

$$\begin{aligned}\text{Fat} &= (\text{Butter} - \$0.045 - \$0.097) \times 1.2 \\ \text{Skim} &= ((\text{CRP} + \$1.535) - (\text{Fat} \times 3.5))/0.965 \\ \text{SNF} &= (\text{Skim} \times 0.76)/9.0 \\ \text{Fluid} &= (\text{Skim} - \text{SNF} \times 9.0)/91\end{aligned}$$

Northern California

$$\begin{aligned}\text{Fat} &= (\text{Butter} - \$0.045 - \$0.097) \times 1.2 \\ \text{Skim} &= ((\text{CRP} + \$1.265) - (\text{Fat} \times 3.5))/0.965 \\ \text{SNF} &= (\text{Skim} \times 0.76)/9.0 \\ \text{Fluid} &= (\text{Skim} - \text{SNF} \times 9.0)/91\end{aligned}$$

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Current Formula

Southern California

$$\begin{aligned}\text{Change} &= \text{CRP} - \$10.1784 \\ \text{Fat} &= \$0.7653 + (\text{Change} \times 0.40/3.5) \\ \text{SNF} &= \$0.7664 + (\text{Change} \times 0.40/8.7) \\ \text{Fluid} &= \$0.0215 + (\text{Change} \times 0.20/87.8)\end{aligned}$$

Northern California

$$\begin{aligned}\text{Change} &= \text{CRP} - \$10.1784 \\ \text{Fat} &= \$0.7653 + (\text{Change} \times 0.40/3.5) \\ \text{SNF} &= \$0.7664 + (\text{Change} \times 0.40/8.7) \\ \text{Fluid} &= \$0.0184 + (\text{Change} \times 0.20/87.8)\end{aligned}$$

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Panel Recommendation

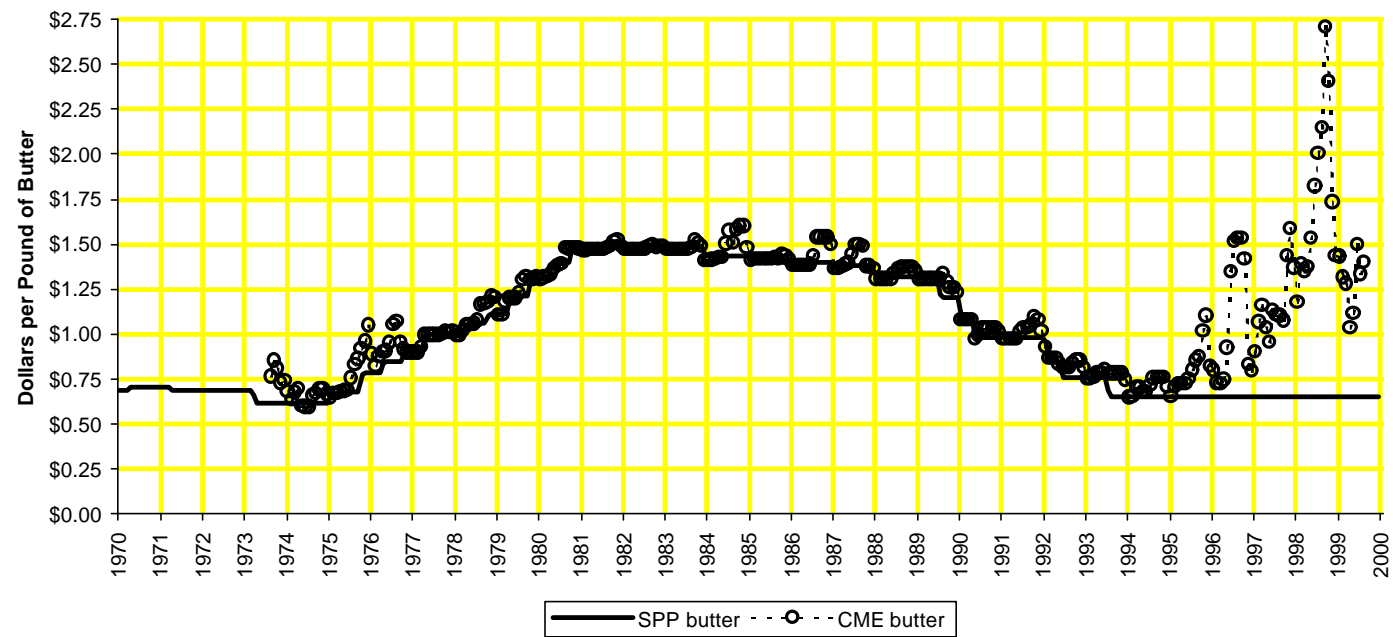
Southern California

$$\begin{aligned}\text{Fat} &= (\text{Butter} - \$0.045 - \$0.097) \times 1.2 \\ \text{SNF} &= ((\text{CRP} + \$0.494) - (\text{Fat} \times 3.5)) \times 0.76/8.7 \\ \text{Fluid} &= ((\text{CRP} + \$0.494) - (\text{Fat} \times 3.5)) \times 0.24/87.8\end{aligned}$$

Northern California

$$\begin{aligned}\text{Fat} &= (\text{Butter} - \$0.045 - \$0.097) \times 1.2 \\ \text{SNF} &= ((\text{CRP} + \$0.494) - (\text{Fat} \times 3.5)) \times 0.76/8.7 \\ \text{Fluid} &= ((\text{CRP} + \$0.494) - (\text{Fat} \times 3.5)) \times 0.24/87.8 - \$0.0031\end{aligned}$$

*Attachment A-6*  
**BUTTER PRICES**  
 Federal Support Purchase Prices (SPP) and Chicago Mercantile Exchange Prices (CME)  
 January 1970 to August 1999



*Attachment A-7*

